INDEPENDENT CONTRACTOR TAX PROPOSALS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2369

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INDEPENDENT CONTRACTOR TAX PROPOSALS

MONDAY, APRIL 26, 1982

U.S. Senate,
Subcommittee on Oversight
of the Internal Revenue Service,
Washington, D.C.

The committee met, pursuant to notice, at 2:13 p.m., in room 2221, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman) presiding.

Present: Senators Grassley and Dole.

[The press release announcing hearings, the text of the bill S. 2369, the description of S. 2369 by the Joint Committee on Taxation, and the prepared statements of Senators Grassley, Dole, and Bentsen follow:]

[Press Release No. 82-122]

Finance Subcommittee on Oversight of the Internal Revenue Service Sets Hearing on Independent Contractor Tax Proposals

Senator Charles Grassley, Chairman of the Subcommittee on Oversight of the Internal Revenue Service, of the Senate Committee on Finance, announced today that the Subcommittee will hold a hearing on Monday, April 26, 1982, on a proposal to be introduced by Senator Bob Dole which would clarify the tax status of independent contractors, and improve tax compliance in the independent contractor sector.

The hearing will begin at 2:00 p.m. in Room 2221 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Grassley stated that he was hopeful that Congress could resolve this year the longstanding independent contractor classification problem. Senator Grassley stated:

"Several proposals have been put forward to resolve the independent contractor classification issue. However, no permanent legislative solution has been adopted. I look forward to studying Senator Dole's new bill, which contains a number of new proposals to improve taxpayer compliance, as well as provisions that would help solve the independent contractor classification problem."

Senator Dole, Chairman of the Senate Committee on Finance announced today the details of the independent contractor tax status bill he will introduce this week. The new bill will contain a safe-harbor definition of independent contractor status, similar to the safe-harbor bill Senator Dole introduced last year, S. 8. In addition, the bill will contain new measures designed to increase the level of voluntary tax compliance in the independent contractor sector.

Senator Dole explained that Congressional action was needed soon, since existing temporary restrictions on IRS employment tax audit activity will expire on June 30, 1982. The existing legislation, which was intended as a temporary measure pending enactment of permanent legislation, bars the IRS from reclassifying workers as "employees" where there was a "reasonable basis" for classifying them as independent contractors under existing common law standards.

Senator Dole stated: "It is time for Congress to provide a permanent solution to the long-standing independent contractor classification problem, together with improved tax compliance measures for independent contractors who are not subject to wage withholding."

The new Dole bill was prepared in consultation with the IRS and the Treasury Department, as well as a wide spectrum of interested members of the public. The bill draws ideas from a number of similar bills that have been introduced in both the Senate and the House in the last several years. Senator Dole expressed his confidence that "the bill reflects a sound compromise position that can be supported by business as well as the Administration."

The major elements of Senator Dole's bill, The Independent Contractor Tax Classification and Compliance Bill of 1982, are as follows:

SAFE-HARBOR CLASSIFICATION RULES

The bill establishes a statutory definition of independent contractor status which a business may elect to rely upon in determining that qualifying workers need not be treated as employees for tax purposes. The bill preserves the existing common law definition as an alternative standard. It also explicitly provides that the elective "safe-harbor" definition is relevant for tax purposes only, and is not to be considered relevant to other employment classification issues.

The safe-harbor definition consists of five separate requirements, each of which must be satisfied.

1. The worker, rather than the person for whom the service is performed (the service-recipient), must control both the aggregate number of hours worked and substantially all of the scheduling of hours worked.
2. If the worker has a principal place of business, it may not be provided by the service-recipient, unless a fair rental is paid.
3. The worker must be economically independent, as demonstrated either: By having more than 90 percent of his remuneration directly related to sales (or other output or services) rather that the number of hours worked; or by having a substantial economic investment in tangible assets of significant value in the performance of the service (excluding vehicles used primarily for transporting the worker).
4. The worker and the service-recipient must agree on the worker's classification as an independent contractor, in a written contract providing adequate notice of the worker's self-employment tax liabilities and disqualification for certain employee tax benefits.
5. The service-recipient must comply with IRS information reporting requirements for payments to independent contractors.

COMPLIANCE MEASURES FOR THE INDEPENDENT CONTRACTOR SECTOR

The bill's compliance provisions are designed primarily to improve compliance with existing IRS information reporting requirements. With the exception of a new reporting requirement applicable only to direct-selling companies, there are no new reporting or recordkeeping burdens imposed on business taxpayers.

1. The bill would create new penalties for failures to file IRS information returns on payments to independent contractors (or for failures to provide copies of such returns to the worker at tax time). The penalties are heavy, but graduated according to the dollar amounts not properly reported, and the proportionate amount of information reporting failures committed by a business in a calendar year.

In the most flagrant case, a business failing to file information returns for more than one-fifth of its independent contractors would face a penalty of 30 percent of the payments not reported. Smaller percentage penalties would be applicable where fewer violations occurred, where there were only partial omissions or failures, where the returns were filed late, or for small businesses with fewer than 5 independent contractor payees. In all cases the penalties would be imposed only if there was no reasonable cause for a violation.

2. In addition, where an independent contractor refused to supply his correct taxpayer identification number, the bill would require the service-recipient to withhold a tax of 15 percent on payments to the independent contractor, until the correct identification number was supplied.
3. Finally, the bill would create a new reporting requirement for direct sellers, whose independent sales representatives are remunerated by retaining a markup on consumer goods purchased for resale in the home. The bill requires the direct seller to file IRS information reports on gross purchases for resale greater than $5,000 per year for any sales representative. In lieu of complying with this "gross purchases" reporting requirement, direct sellers may elect to provide greater information on commissions and sales bonuses paid (the reporting threshold would be $50 instead of $600) together with information reports identifying their full active sales force.

STATEMENT OF SENATOR CHARLES E. GRASSLEY

I'd like to call this hearing of the Subcommittee on Oversight of the Internal Revenue Service to order. The topic of our hearing today is the tax treatment of independent contractors and Senator Dole's proposed solution to that problem, S. 2369.

The problem of defining independent contractors for tax purposes has long-plagued the IRS, employers and workers. Concerned about the loss of employment taxes, the IRS increased audits in the late 1960's. The Service's efforts were aimed at reclassifying insurance agents, direct sellers and real estate agents as employees rather than independent contractors. The effect of this change was to make employers liable for unpaid employment taxes, including wage withholding, social security, and unemployment taxes.

During the 1970's the IRS resumed their enforcement effort, which led to the congressional enactment of the Revenue Act of 1978 which included a provision terminating an employer's back tax if the employer had any reasonable basis for treating his workers as independent contractors. This appropriation's rider also prohibited the issuance of any regulations or revenue rulings on the common law employment status. This moratorium has been extended numerous times and expires June 30, 1982.

Senator Dole has introduced legislation which defines independent contractors for tax purposes by creating a five factor safe harbor test which workers must meet to be considered independent contractors for tax purposes. If workers do not meet all 5 factors, they may still be considered independent contractors for tax purposes if they meet the common law test. This approach has merit because the safe harbor gives the employer and employee certainty about the tax treatment of their relationship. Retention of the common law test injects fairness into the classification process, insuring that no independent contractor under common law will lose his tax status merely because Senator Dole's bill is passed. Senator Dole's bill also includes new information reporting requirements and new penalties for those who fail to comply.

Senator Dole deserves great praise for his legislation initiative. He has managed to forge a compromise among groups with widely divergent interests. This compromise resulting in S. 2369 has been a long and difficult battle. All affected parties are to be complimented for their self-discipline in achieving this goal. Senator Dole's leadership and the hard work of his staff have made this legislation possible. Because this is such a fine measure, I'd like to announce my co-sponsorship of it.

Before we hear the comments of our witnesses, I'd like to ask the Chairman and Senator Baucus if they have any opening statements.

STATEMENT OF SENATOR BOB DOLE FOR HEARING ON INDEPENDENT CONTRACTOR TAX BILL

INTRODUCTION

I thank the distinguished Senator from Iowa, Chairman of the Subcommittee on Internal Revenue Service Oversight, for scheduling an early hearing on the Independent Contractor legislation proposed by this Senator and others, including, I might add, seven other Members of the Finance Committee. I am particularly gratified that Senator Grassley has today announced his intention to join as a cosponsor of the legislation.

TIME IS RUNNING OUT

Although this is an early hearing, time is running out on our efforts to produce a compromise solution to the independent contractor tax controversy. The existing moratorium on IRS audit and regulatory activity in the independent contractor area expires on June 30, 1982. But more important than just the existence of a deadline, is recognition of the fact that continued preservation of the status quo—through extensions of the 1978 moratorium—is not revenue-neutral. Although we have no hard revenue estimates from the Joint Committee on Taxation, the moratorium would appear to be a revenue loser, in a variety of direct and indirect ways. It is time for Congress to provide a permanent solution—or at least to try our hands at a solution—to the important tax problems involving the classifications of workers as independent contractors.

THREE PROBLEMS MUST BE ADDRESSED

There are three major problems of concern to the Congress. First, a solution must be found to the growing tax compliance problem among self-employed workers not subject to wage withholding. Improving business compliance with information reporting rules now on the books, and adding some new rules, where needed, is a feasible and necessary step in this direction. This is one goal of S. 2369, the Independent Contractor Tax Classification and Compliance Bill of 1982.

Second, businesses must have clear rules to provide greater certainty in deciding how to classify their workers for tax purposes, either as employees or independent contractors.

Congress has clearly expressed its desire to distinguish between employees and the self-employed for various tax purposes. A reasonable safe-harbor definition of independent contractors should help a large number of taxpayers to classify their workers with greater certainty. By preserving the common law standard as an alternative test, the law will retain its flexibility as the economy changes and new industrial relationships develop. Enacting such an approach is the second goal of S. 2369.

Finally, for those businesses whose workers will not fall within the safe-harbor, procedural reforms in the employment classification area must be enacted. The General Accounting Office has pointed out that retroactive reclassifications often result in double taxation, where workers who thought they were properly classified as self-employed did in fact properly report and pay their income and social security taxes. Procedural reforms may help eliminate this inequity.

In addition, since the law in this area will probably never be completely settled, it may be appropriate for Congress to consider limiting the retroactive liability of an employer for withholding taxes where the employer reasonably, and in good faith, may have misclassified certain employees as independent contractors. Similar relief may also be appropriate where the qualification of retirement plans may be jeopardized by good faith, reasonable misclassifications.

Although S. 2369, as introduced, does not address these procedural problems, I believe the Finance Committee should address the procedural problems in the employment classification area when it addresses the provisions of S. 2369 as introduced.

DISTINGUISHED WITNESSES WILL TESTIFY

I look forward to hearing the testimony of the distinguished witnesses testifying on the interrelated tax problems affecting independent contractors. The hearing process is a necessary and useful part of our efforts to assure that the needs and concerns of interested parties are reflected in the legislation as it is reported out of the Finance Committee.

Mr. Chairman, at this time, without objection, I would like to have entered in the hearing record the text of an explanation of S. 2369, which I gave when introducing the bill on the Senate Floor.

THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982

This bill deals with two problems that have been of serious concern to the Congress for some time: clarifying the circumstances when a business can safely treat certain workers as independent contractors rather than employees, and improving the level of tax compliance among independent contractors who are exempt from the wage withholding provisions generally applicable to employees.

THE CLASSIFICATION PROBLEM

Since the early 1970's the Internal Revenue Service has undertaken an aggressive campaign to audit the employment tax liabilities of business taxpayers. In this effort the IRS has tried to recharacterize as employees many individuals who were traditionally considered independent contractors. This increase in audits, and retroactive tax assessments, has imposed a great burden on many businesses that relied upon long-standing characterization of certain workers as independent contractors. Much of the problem with the IRS reclassification campaign stemmed from the absence of clear statutory rules defining the difference between an employee and an independent contractor for tax purposes.

Independent contractors are required to make estimated tax payments on a quarterly basis, and to pay self-employment taxes to the social security system. Accordingly, they are generally exempt fom the wage withholding rules applicable to employees.

To a business, the distinction between an independent contractor and an employee is important precisely because businesses are not required to withheld on payments to independent contractors, or to pay social security or unemployment taxes on such payments. Thus, if the IRS prevails in reclassifying certain workers as employees, a business that contracted with an independent contractor to have services performed can become an "employer", liable for a very large retroactive assessment of employment taxes which were not withheld or paid to the Treasury. Indeed, in many cases, even where the IRS is unsuccessful in its reclassification efforts, the burden of defending against a large retroactive assessment can be very onerous.

THE COMPLIANCE PROBLEM

The IRS campaign to recharacterize independent contractors as employees was prompted, in part, by well-meaning, legitimate concern that certain independent contractors were not reporting all of their compensation, thereby avoiding their fair share of income tax liability. From the perspective of the IRS, reclassifying workers as employees was a quick and easy solution to this tax compliance problem, because the estimated level of tax compliance for employees subject to wage withholding is in excess of 99 percent, according to the IRS. Nevertheless, this approach to improving compliance was not only unduly burdensome to business, it was counterproductive, since the IRS actually lost many cases where it tried to reclassify independent contractors as employees. Moreover, since 1978 Congress has prevented the IRS from proceeding with its reclassification campaign, because of the unreasonable burdens this campaign imposed on business taxpayers.

PRIOR LEGISLATIVE PROPOSALS

In 1979, this Senator first introduced a bill to clarify the status of workers providing services as independent contractors. At that time the IRS again sought to sidestep the classification issue by seeking to require wage withholding for all workers, regardless of their status. This IRS proposal was never adopted, since many Members thought that withholding was an inappropriate, impractical and overly burdensome response to the legitimate concerns of the IRS. It was felt that some other approach was needed, but in the last several years Congress has been unable to develop a satisfactory answer to the IRS' concerns with tax compliance in the independent contractor sector. Similarly, Congress has been unable to provide permanent relief to businesses subject to the threat of IRS reclassifications efforts.

TEMPORARY RELIEF EXPIRES IN JUNE

Since 1978, Congress has provided a temporary solution to the reclassification problem by allowing businesses to continue to treat workers as independent contractors if there was a "reasonable basis" for treating them as independent contractors in the past. When I sponsored the first such measure, the intention was simply to preserve the status quo until Congress had an opportunity to fashion a permanent solution. When the first temporary measure expired, at the end of 1980, this Senator was reluctantly forced to offer an additional 18-month extension of the status quo. The present moratorium expires on June 30, 1982. It is plainly time for Congress to provide a permanent solution to the classification problem, together with improved compliance measures for the independent contractor sector. That is why I am today introducing the Independent Contractor Tax Classification and Compliance Bill of 1982.

THE SCOPE OF THE "SAFE-HARBOR" BILL

The Independent Contractor Tax Classification and Compliance Bill of 1982 provides clear standards, which a business can elect to rely upon, to determine that certain workers are not employees, for tax purposes. The bill preserves the common law standard as an alternative test for classifying workers, and also provides that the new "safe-harbor" standards are relevant for tax purposes only. Under no circumstances are the safe-harbor provisions to be considered in determining an individual's employment status for any other purposes.

OVERVIEW OF THE SAFE-HARBOR TESTS

In order to meet the safe-harbor test, there are several formal requirements that must first be satisfied. The worker and the person for whom the work is being performed (the service-recipient) must agree, by written contract, that the service will be performed by the worker as an independent contractor. The written contract, executed before the service is performed, must apprise the worker of his self-employment tax responsibilities, and his disqualification for various employee benefits under the tax law. Finally, the service-recipient must file all required information returns for his payments to the worker.

In addition to these preliminary formal requirements, the worker must actually be an independent business person, as demonstrated by his satisfying three requirements. First, the worker must control the aggregate number of hours he works, and substantially all the scheduling of his hours. Secondly, if the worker has a principal place of business, it cannot be provided for him by the service-recipient, unless a fair rental is paid. Third, the individual providing services as an independent contractor must be an economically independent business person, a requirement that can be met in two ways. The worker must either risk income fluctuations (because he is paid on the basis of sales or other output, rather than the number of hours worked) or he must have a substantial economic investment in tangible assets used in the performance of the service.

DETAILED ANALYSIS OF THE SUBSTANTIVE SAFE-HARBOR TESTS

The safe-harbor tests contained in this bill are very similar to the tests contained in the safe-harbor bill I introduced last year, S. 8. Some changes have been made following extensive consultations with IRS and Treasury officials, as well as industry representatives.

THE "CONTROL OF HOURS" TEST

The first test requires that the worker, rather than the service-recipient, have control over the aggregate number of hours worked, as well as substantially all of the scheduling of his hours. This test is almost identical to the "control of hours" test contained in S. 8. This bill, however, provides that certain extraneous factors (specifically, government regulations, contractual obligations of the service-recipient, coordination of work imposed by third parties, and general limitations on access to the service-recipient's premises) may be disregarded in determining whether the worker controls the scheduling of his hours.

A worker will plainly satisfy both parts of this test if he is hired simply to accomplish a particular result, without regard to the amount of time spent, or the time of day (or night) his services are performed. For example, an insurance salesman controls his hours and the scheduling of his hours for purposes of this test if he is hired and compensated only for selling insurance policies, is not required to maintain regular hours or work any minimum amount of hours, and is free to contact his potential customers at the times he sees fit. However, a salesman who is required to work a particular minimum number of hours on a regular basis, or to attend customers during particular office hours specified by the service-recipient, will not meet the control of hours test, since the service-recipient controls the aggregate minimum amount of hours worked and more than an insubstantial amount of the scheduling of the hours worked.

When a worker is hired on an hourly basis, or hired to perform tasks that must be performed within a certain minimum amount of time, the control of hours test can still be satisfied if the nature of the relationship between the worker and the service-recipient is such that worker is free to accept or refuse specific jobs as he sees fit, and substantially free to schedule the times at which he performs the services. For example, a truck owner-operator may contract with a shipping company to haul a load of goods from New York to Los Angeles, with a specific contract deadline. If the nature of the legal and economic relationship is such that, say, when the owner-operator arrives in Los Angeles he is free to decline a subsequent contract offered by the company to haul additional goods from Los Angeles to New York, then the owner-operator will meet the requirement that he control the aggregate number of hours worked. However, if the trucking company can effectively require the owner-operator to accept the contracts that the company offers, the owner-operator will not be deemed to be controlling the aggregate number of hours worked, since the company can control the minimum amount of work performed, much as if the owner-operator were an employee. A similar analysis would apply to a dump truck owner-operator performing services at a construction site. If the dump-truck owner-operator is effectively precluded from refusing contracts with a particular general construction contractor, then the control of hours test would not be satisfied.

In the previous example of the truck owner-operator, the owner-operator must still meet the requirement that he control the scheduling of his hours worked. However, the owner-operator will not be deemed to fail this requirement merely because government regulations limit the number of hours he can drive per day, or because the shipping company's contract with its customer requires the goods to be delivered by a certain date. Similarily, if the services performed by the dump truck owner-operator are coordinated with services performed, for example, by the operator of a back-hoe, that coordination will not disqualify the dump truck owner-operator from meeting the "scheduling" test if the coordination is imposed by a party, (for example, the owner of the building being built) other than the service-recipient. The "scheduling" test could also be satisfied if the dump-truck owner-operator's services were subject to scheduling control only to meet the service-recipient's contractual obligations to the building owner.

The "scheduling control" that may not be exercised by the service-recipient under this test is the control typically exercised by an employer, that is, requiring that the worker begin work no later than a certain time and continue working until a certain time. Accordingly, the bill provides that if work is performed on the premises of the service-recipient and access to the premises is generally limited to a specified period of time, the worker may still meet the scheduling test so long as, within the period of limited access, the worker controls the scheduling of his hours. In such a case, of course, the service-recipient is not exercising control over the worker's scheduling in the manner typically exercised by an employer, but is merely imposing outer limits on the time the worker can begin, and the latest time until which the worker may continue to work.

Similarly, if a service-recipient coordinates the order or manner in which certain work prejects are performed on a work site, but the worker, such as a drilling rig welder, still controls the scheduling of the hours he works in the sense that he determines when he will begin and end work, the scheduling test would be satisfied.

THE "PLACE OF BUSINESS" TEST

The second substantive test is that the worker's principal place of business with respect to the service may not be provided for him by the service-recipient, unless a fair rental is paid to the service-recipient. Of course, the worker need not maintain a principal place of business at all. If he does, however, it cannot be provided by the service-recipient without payment of a fair rental.

There are often situations where salesmen (for example, in the real estate or insurance industry) are provided with a desk, telephone, or other basic business accommodations on the service-recipient's premises. The bill clarifies that such facilities are not deemed a principal place of business if the individual performs substantially all the services he performs for the service-recipient away from the service-recipient's premise.

The "place of business" test in this bill is substantially the same as the "place of business" test contained in S. 8.

THE "ASSETS" OR "INCOME FLUCTUATION" TEST

The final test is designed to ensure that the worker is economically independent from the service-recipient, in a manner that is typical of an independent contractor, and foreign to the traditional employer-employee relationship. This test can be satisfied in two alternative ways. The first alternative requires that the individual risk fluctuations in his income as a service provider because he is not paid on an hourly basis, but is paid on the basis of sales, or the successful completion of certain services. An individual satisfying this alternative is economically independent from the service-recipient because he is not assured of any substantial economic return for the time he spends providing services for the service-recipient.

The second alternative requires that the individual bear economic risk because of a substantial economic investment by the individual in assets used in the performance of the service. The individual meeting this test may be paid by the hour, and may thus be assured a minimum amount of remuneration for his labor. But the individual may nevertheless bear economic risk in his activities as a service provider because he supplies assets that are of significant value in the performance of the services, and has a substantial economic investment in such assets. This test could be met by a dump-truck owner-operator, or the owner-operator of a cement mixing truck, who is paid on an hourly basis, but provides his own equipment, and therefore risks economic loss if he is unable to obtain more jobs on a continuing basis.

The investment required by this test may be by purchase or lease, and there is no fixed rule against buying or leasing an asset from a service-recipient. However, the bill contemplates that the nature of any such investment will be scrutinized, in relationship to the remuneration received by the individual from the service-recipient, to determine whether the individual is truly bearing substantial economic risk. If the individual has both a leasing arrangement and a long term service contract with a service-recipient, the two contracts may effectively nullify any substantial economic risk on the part of the individual. However, the fact that a service-recipient sells, finances, or leases an asset to an individual will not automatically disqualify that arrangement from satisfying this test. The test in all cases will be whether the individual bears economic risk in his activities as a service provider because of a substantial economic investment in tangible assets of significant value in the performance of the services.

Even when the assets are purchased or leased from a third party, this test looks to the nature and the amount of the remuneration received from any service-recipient to determine whether the worker's investment is substantial. For example, a long term service contract with one service-recipient, guaranteeing a minimum amount of remuneration over a long period of time, may nullify any economic risk in the worker's ownership of certain assets used in providing services to that service-recipient. But where the worker owning or leasing assets must contract with numerous service-recipients in order to recoup his investment costs and profit from his activities as a service provider, the worker would ordinarily satisfy the test.

In some cases, workers, provide their own hand tools, but the cost of the tools are not such as would create a substantial economic risk for purposes of this "assets" test. The worker providing such tools may, in certain cases, be permitted to treat the cost of using his car, pick-up, or van as a business expense, because the tools are too heavy or bulky to carry or transport on public transportation. In such cases, the bill provides that the tools themselves must meet the "substantial investment" test, without counting any vehicle used primarily to transport the worker and his tools, samples or similar items.

A vehicle used primarily for performing services, however, is not excluded under this rule. Moreover, if certain tools or equipment are affixed to a vehicle used for transporting the worker, the value of the tools and equipment affixed to the vehicle may be considered part of the worker's qualifying investment. For example, if a contract welder regularly drives to construction sites in a truck (a welding rig) to which is affixed a welding forge, gas tanks and welding equipment, the equipment could be considered part of the worker's investment even though the basic truck, itself, might be disqualified.

MEASURES TO IMPROVE TAX COMPLIANCE IN THE INDEPENDENT CONTRACTOR SECTOR

In addition to the save-harbor classification provisions, this bill proposes new compliance measures that should substantially improve voluntary tax compliance in the independent contractor sector.

IMPROVING INFORMATION RETURN COMPLIANCE

The key to better voluntary tax compliance in the independent contractor sector is improved information reporting on payments by service-recipients to independent contractors. Information returns give the IRS the ability to make certain that independent contractors are accurately reporting their gross business receipts. In addition, when copies of information returns are provided to the taxpayer, at tax time, the taxpayer is reminded of the precise amounts required to be included in his tax return.

With one exception, of limited application, this bill does not create any new information reporting or recordkeeping requirements. The major problem with current law is not the information reporting rules on the books, but rather the fact that there is substantial noncompliance with these rules. A key compliance provision of this bill is a new penalty system designed to put teeth in the information reporting requirements for the first time.

In essence, the bill treats accurate information reporting as the keystone of improved tax compliance in the independent contractor sector. This approach is essential because of the absence of withholding on payments to independent contractors.

Under this bill, a service-recipient making payments of compensation to an independent contractor would face substantial penalties for failing to file information returns with the IRS, or for failing to report such payments to the independent contractor, at tax time. Instead of a fixed dollar penalty, the bill would impose a percentage penalty based on the amount of compensation that was not properly reported. For example, if payments of $2,500 were not properly reported (to the IRS and the taxpayer) the penalty could be as high as $250, 10 percent of the amount not properly reported. If the information report was merely late (by up to four months), or was filed on time but reported less than the full amount required to be reported, or if the payor reported properly to the IRS, but failed to provide a copy of the report to the payee, the penalty imposed would be a percentage smaller than 10 percent, depending on the circumstances. Of course, these penalties apply only to businesses failing to file required information reports and statements.

In addition to this basic penalty of up to 10 percent of the amount not properly reported (with a smaller percentage penalty for partial violations, incomplete reports, and late filings), an additional penalty would be imposed if the service-recipient was a multiple offender. In any calendar year, so long as the service-recipient properly reports at least 90 percent of information returns required on payments to independent contractors, no additional penalty is imposed. But if more than a tenth of the required reports are not properly filed, the total penalties are increased to up to 20 percent of the amounts not reported. If more than a fifth of the reports are not filed, the total penalties will be increased to up to 30 percent of the amounts not properly reported. (Again, if the service-recipient has committed multiple violations, but the violations consist of partial violations, incomplete reports, or late filings the percentage penalties will be smaller.)

In all cases, of course, no penalties will be imposed if a failure, or violation, is due to reasonable cause and not to willful neglect. But, in the worst possible case, where a flagrant violator completely fails to file more than a fifth of the required information returns, the total penalty can be as high as 30 percent of the amounts not properly reported. (For example, if a business is required to file returns on 100 contractors receiving $1,000 each per year, and fails completely to report information on half of them, the total penalty imposed would be $15,000. That penalty is precisely equal to 30 percent of the amounts not properly reported, i.e., $50,000.)

Because the penalties are graduated, there is little cause for concern that minor mistakes or slip-ups will result in unduly harsh penalties. However, the same graduated penalty system should give businesses a substantial incentive to properly comply with the information reporting rules already on the books.

This system should also discourage intentional nonfiling of information returns, and intentional filing of incomplete returns.

Under the bill, these penalties technically apply only to information reports for payments by persons in a trade or business to other "persons" as compensation for services. This statutory reference to "persons" receiving compensation for services tracks the statutory language of current law which requires reports on payments to all "persons", a term which technically includes corporations. The Treasury, of course, will have regulatory authority to limit application of these rules to payments to individuals if it determines that reports on payments to corporations are unnecessary.

INFORMATION REPORTING FOR DIRECT SELLERS

The only new reporting or recordkeeping requirement created by this bill is a requirement applicable to direct sellers of consumer goods for resale in the home on a buy-sell or deposit-commission basis. These direct sellers will be required to file information reports with the IRS on the total amount of gross purchases by their sales representatives, if the amount of purchases by their representative in any year is over $5,000 (excluding goods which cannot be resold, such as catalogues or display items). As an alternative, direct sellers may elect to file regular information returns for sales commissions at a lower annual dollar threshold ($50 per year, per recipient, instead of $600). To qualify for this election, the direct seller must also file annual information reports identifying substantially all of their active sales force. In all cases, copies of the information reports must be sent to the representative.

When a direct seller is required to file more than one type of information report for the same sales representative (e.g. a gross purchases report together with a commission report, or a commission report together with an identifying report) the direct seller should be allowed to file both reports on one form. The bill contemplates that this rule, as well as other rules regarding the proper forms for information reporting, would be promulgated through Treasury regulations.

The information that can be obtained from these reports should be helpful to the IRS compliance effort. Moreover providing copies of the reports to direct selling representatives should help remind them of their tax responsibilities at tax time.

WITHHOLDING IN CERTAIN CASES

Finally, this bill also applies to the independent contractor sector the temporary withholding rules proposed in the Dole-Grassley Taxpayer Compliance Improvement Act of 1982 (S. 2198), for situations where an independent contractor fails to supply an accurate identifying number to the service-recipient.

THE PROBLEM OF OVERSTATED DEDUCTIONS

The compliance measures of this bill are directed primarily to the problem of unreported and underreported income. Of course, Treasury Department studies, as well as recent news reports, clearly indicate that unreported income is only part of the tax compliance problem. Overstated deductions are also a serious problem, among self-employed individuals and taxpayers generally.

Where the problem of overstated deductions exists, the IRS may need to develop improved audit techniques. In addition, some changes in IRS tax forms may be helpful to discourage taxpayers from taking questionable or fraudulent deductions. Although this bill does not directly deal with the problem of overstated deductions by independent contractors, it should substantially improve voluntary tax compliance by reducing the amount of unreported income on the part of independent contractors.

HEARINGS HAVE BEEN SCHEDULED

It is imperative that Congress act on the independent contractor issue before the end of June, when the present moratorium on IRS reclassifications expires. I am therefore pleased that the distinguished Senator from Iowa, Senator Grassley, Chairman of the Finance Subcommittee on Oversight of the Internal Revenue Service, has announced that his subcommittee will hold a hearing on the bill on April 26, 1982.

In drafting this bill we have worked closely with interested members of the public, as well as the IRS and the Treasury Department. I am confident that this bill reflects a sound, compromise position that can be supported by business as well as the Administration.

The safe-harbor provisions of this bill should work to provide much needed certainty in classifying workers for tax purposes. At the same time, I believe that this bill does not permit any workers now classified as employees under the common law to switch their status to that of an independent contractor without substantial changes in the nature of their relationship with their employer. I know that the Treasury Department would be concerned if this were a real possibility. Accordingly, I would be happy to listen to any comments they have if there are any specific examples of current law employees who would, under this bill, be able to switch over to independent contractor status without a substantial change in their relationship to their employer.

As to the industry's concerns, I believe this bill describes within its safe harbors the majority of independent contractors whose service-recipients are in serious risk of unreasonable IRS reclassification efforts. This bill does not describe all independent contractors, however, and for that reason it retains the common law as an alternative standard. I cannot emphasize strongly enough that the safe-harbor provisions are not designed to replace the common law, but are merely designed to provide a clearer legal standard for a large number of workers who do fall clearly within the narrow tests this bill provides.

COMMENTS INVITED REGARDING PROCEDURAL ISSUES IN EMPLOYMENT TAX AUDITS

This bill, if enacted, should go a long way towards providing business taxpayers with greater certainty in classifying their workers for tax purposes. But this bill may not solve all of the problems associated with IRS employment tax audits.

Some workers who qualify as independent contractors under the common law will not qualify under the safe-harbor provisions of this bill. A business classifying such workers as independent contractors may be subjected to an IRS reclassification effort, notwithstanding the existence of judicial precedent, or an IRS ruling, justifying the decision to classify the workers as independent contractors under the common law.

Some have suggested that when a business has acted reasonably, and in good faith, in classifying certain workers as independent contractors, it may be inappropriate to subject that business to the risk of a retroactive assessment for the full amount of the taxes it failed to withhold from its workers. In certain cases, the workers themselves may have paid their correct income and social security self-employment taxes, notwithstanding the absence of withholding. But the business may have difficulty obtaining the records necessary to show that the workers' taxes were paid. In other cases, the sheer magnitude of a retroactive assessment may deter a business from contesting an IRS reclassification, even where the business was justified in treating its workers as independent contractors. The threat of a large retroactive assessment may induce settlement with the IRS in cases where the business was entirely correct in its actions.

For these reasons, and others, it may be appropriate for Congress to consider limiting the extent to which employment status reclassifications could result in large retroactive assessments, where a reasonable basis existed for a business decision to classify workers as independent contractors.

Congress might also wish to consider other procedural changes that might ease the threat of retroactive reclassifications, such as providing a declaratory judgment procedure for employment classification issues, or allowing prepayment Tax Court review of employment tax assessments. Still other suggestions for procedural reforms have been advanced in the past, and perhaps there are new ideas as well.

At this time, I am not committed to any particular approach. But I am concerned about the procedural problems that may remain, even if this bill is passed, for certain businesses whose workers are not described in the safe-harbor provisions. Accordingly, when this bill is considered in the Finance Committee, I would welcome comments from the Treasury Department and the IRS, as well as interested representatives from business and labor, regarding procedural problems in the employment tax area and possible legislative responses.

STATEMENT OF SENATOR LLOYD BENTSEN

Mr. Chairman, I strongly support S. 2369, The Independent Contractor Tax Classification and Compliance Act. This compromise bill is designed to clarify and simplify the rules concerning who will be deemed to be an independent contractor, and thus end the confusion and litigation surrounding this issue. Although the bill is not perfect, and future adjustments might have to be made, it goes a long way towards an ultimate solution of this long-standing problem.

For several years now, I have endeavored to eliminate tax barriers to productivity. This bill addresses one such barrier, the barrier of confusion that has caused many Americans to hesitate before becoming independent contractors. They justifiably fear becoming embroiled in legal controversies over their tax status. Yet in these days of high unemployment and low productivity, independent contractors are vital to the economic health of the nation. Independent contractors, like small businessmen, display the drive, initiative and dedication that are so necessary to increasing productivity and getting this country back on its feet. Tax laws that create unjustified barriers to independent contractor status are neither good tax policy nor good economic policy.

This bill is a compromise, but it is a workable compromise. It provides for a "safe-harbor" statutory definition of an independent contractor, consisting of only four tests compared to the twenty factors examined under current law. This will allow both individuals and businesses to know if a worker should be treated as a contractor or as an employee, without having to resort to litigation. Moreover, except for a slight increase for direct sellers, this bill will result in no extra paperwork. Finally, this bill provides for strict penalties as a deterrent to those few individuals who would abuse the rules and evade taxes.

Mr. Chairman, S. 2360 helps to rationalize and simplify our tax system. I compliment you for your work in pushing it forward. I support it without reservation and urge every other member to do so also.

Thank you very much.

II

97TH CONGRESS
2D SESSION

S. 2369

To amend the Internal Revenue Code of 1954 to clarify the standards used for determining whether individuals are not employees for purposes of the employment taxes, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 14 (legislative day, APRIL 13), 1982

Mr. DOLE (for himself, Mr. DANFORTH, Mr. BOREN, Mr. WALLOP, Mr. SYMMS, Mr. ROTH, Mr. JOHNSTON, Mrs. KASSEBAUM, Mr. LAXALT, and Mr. DURENBERGER) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to clarify the standards used for determining whether individuals are not employees for purposes of the employment taxes, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Independent Contractor Tax Classification and Compliance Act of 1982".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. ALTERNATIVE STANDARDS FOR DETERMINING FOR PURPOSES OF EMPLOYMENT TAXES WHETHER INDIVIDUALS ARE NOT EMPLOYEES.

(a) IN GENERAL.—Chapter 25 (relating to general provisions relating to the employment taxes) is amended by adding at the end thereof the following new section:

"SEC. 3508. ALTERNATIVE STANDARDS FOR DETERMINING FOR PURPOSES OF EMPLOYMENT TAXES WHETHER INDIVIDUALS ARE NOT EMPLOYEES.

"(a) GENERAL RULE.—Notwithstanding any other provision of this subtitle, solely for purposes of this subtitle (other than chapter 22) and chapter 2, if all of the requirements of subsection (b) are met with respect to service performed by any individual—

"(1) such service shall be treated as being performed by an individual who is not an employee, and

"(2) the service-recipient shall not be treated as an employer with respect to such service.

"(b) **REQUIREMENTS.**—The requirements referred to in subsection (a) are as follows:

"(1) **CONTROL OF HOURS WORKED.**—The individual controls the aggregate number of hours worked and substantially all of the scheduling of the hours worked.

"(2) **PLACE OF BUSINESS.**—

"(A) **IN GENERAL.**—No principal place of business of the individual (if any) with respect to the service is provided by the service-recipient unless the individual pays such service-recipient rental which, under the facts and circumstances, is a fair rental.

"(B) **SPECIAL RULE FOR DETERMINING PRINCIPAL PLACE OF BUSINESS.**—For purposes of subparagraph (A), no place of business which is provided an individual by a service-recipient with respect to any service shall be treated as a principal place of business of such individual with respect to the service if substantially all of the service performed by the individual for the service-recipient is not performed at such place of business or any other place of business provided by the service-recipient.

"(3) **INVESTMENT OR INCOME FLUCTUATION.**—

"(A) IN GENERAL.—The individual—

"(i) has an investment in tangible assets used by the individual in connection with the performance of the service, but only if—

"(I) such assets are of significant value in the performance of the service, and

"(II) such investment is a substantial economic investment in light of the nature and amount of the remuneration received for the service, or

"(ii) risks income fluctuations because more than 90 percent of the remuneration (whether or not paid in cash) for the performance of the service is directly related to sales or other output rather than to the number of hours worked.

"(B) SPECIAL RULES.—

"(i) CERTAIN VEHICLES NOT TAKEN INTO ACCOUNT.—An investment by an individual in any vehicle which is used primarily to transport the individual (and any tools, samples, or similar items) shall not be taken into account for purposes of subparagraph (A)(i).

"(ii) OTHER OUTPUT.—For purposes of subparagraph (A)(ii), the term 'other output' includes the performance of services but does not include piecework.

"(4) WRITTEN CONTRACT AND NOTICE OF TAX RESPONSIBILITIES.—

"(A) WRITTEN CONTRACT.—The individual performs the service pursuant to a written contract between the individual and the service-recipient—

"(i) which was entered into before the performance of the service, and

"(ii) which provides that the individual will not be treated as an employee with respect to such service—

"(I) for purposes of the Federal Insurance Contributions Act, the Social Security Act, the Federal Unemployment Tax Act, and income tax withholding, and

"(II) for purposes of the employee benefit provisions specified in subsection (e)(2).

"(B) NOTICE OF TAX RESPONSIBILITIES.— The individual is given written notice (in such contract or at the time such contract is executed) which is designed to ensure that the individual understands his responsibilities with respect to the payment of Federal self-employment and income taxes.

"(5) FILING OF REQUIRED RETURNS.—The service-recipient meets the requirements of section 6041A in respect of such service at the times prescribed therefor (including extensions thereof) unless the failure to meet such requirements is due to reasonable cause and not to willful neglect.

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) SERVICE-RECIPIENT.—For purposes of this section, the term 'service-recipient' means the person for whom the service is performed.

"(2) SECTION NOT TO APPLY TO CERTAIN INDIVIDUALS.—This section shall not apply to an individual described in paragraph (3) of section 3121(d) (relating to certain agent-drivers, commission-drivers, full-time life insurance salesmen, homeworkers, and traveling or city salesmen). For purposes of the preceding sentence, the determination of whether an individual is described in such paragraph (3) shall be made without regard to whether or not such individual is also described in paragraph (1) or (2) of section 3121(d).

"(3) SPECIAL RULE FOR CONTRACTS ENTERED INTO BEFORE JANUARY 1, 1983.—With respect to written contracts entered into before January 1, 1983, subsection (b)(4)(A) shall be deemed to be satisfied if—

"(A) such written contract clearly indicates that the individual is not an employee (either by specifying that the individual is an independent contractor or otherwise), and

"(B) the notice described in subsection (b)(4)(B) is provided before January 1, 1983.

"(4) SPECIAL RULE FOR DETERMINING CONTROL OF SCHEDULING OF THE HOURS TO BE WORKED.—For purposes of subsection (b)(1), an individual shall not be treated as not controlling any scheduling of hours worked merely because such individual's control is limited as a result of—

"(A) Government regulatory requirements,

"(B) operating procedures and specifications the service-recipient is required by contract to comply with (other than a contract with such individual),

"(C) the coordination of the performance of the service with the performance of other services but only if such coordination is done by a person other than the service-recipient or a related person, or

"(D) the control of access to any premises by the service-recipient but only if such individual controls the scheduling of hours during the period during which such access is granted.

"(d) NO INFERENCE WHERE STANDARDS ARE NOT MET.—If not all of the requirements of subsection (b) are met with respect to any service—

"(1) nothing in this section shall be construed to imply that the service is performed by an employee or that the service-recipient is an employer, and

"(2) any determination of such an issue shall be made as if this section had not been enacted.

"(e) RELATIONSHIP TO OTHER PROVISIONS OF LAW.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the fact that all of the requirements of subsection (b) are met with respect to service performed by an individual—

"(A) shall not be construed to imply that, for purposes of any provision of law other than chapters 2, 21, 23, and 24, the service is not performed by an employee or the service-recipient is not an employer, and

"(B) any determination of such an issue shall be made as if this section had not been enacted.

"(2) INDIVIDUAL NOT ENTITLED TO EXCLUSION FOR CERTAIN BENEFITS.—If all of the requirements of subsection (b) are met with respect to service performed by an individual, such individual shall not be treated as an employee for purposes of applying the provisions of—

"(A) section 79 (relating to group-term life insurance purchased for employees),

"(B) section 101(b) (relating to employees' death benefits),

"(C) sections 104, 105, and 106 (relating to accident and health insurance or accident and health plans),

"(D) section 120 (relating to group legal service plans),

"(E) section 127 (relating to educational assistance programs),

"(F) section 129 (relating to dependent care assistance programs), and

"(G) so much of subtitle A as relates to contributions to or under, or distributions under, a stock bonus, pension, profit sharing, or annuity plan, or by a trust forming part of such a plan.

Subparagraph (G) shall not apply to individuals treated as employees under section 401(c)(1) (relating to self-employed individuals).".

(b) AMENDMENT OF SOCIAL SECURITY ACT.—Section 210 of the Social Security Act is amended by adding at the end thereof the following new subsection:

"Alternative Standards for Determining
Whether Individuals Are Not Employees

"(p) Notwithstanding any other provision of this title, the rules of section 3508 of the Internal Revenue Code of 1954 shall apply and any reference in such section to chapter 2 or 21 of such Code shall be deemed to include a reference to this title.".

(c) CLERICAL AMENDMENT.—The table of sections for chapter 25 is amended by adding at the end thereof the following new item:

> "Sec. 3508. Alternative standards for determining for purposes of employment taxes whether individuals are not employees.".

SEC. 3. INFORMATION REPORTING REQUIREMENTS FOR PAYMENTS OF REMUNERATION FOR SERVICES AND DIRECT SALES.

(a) GENERAL RULE.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by inserting after section 6041 the following new section:

"SEC. 6041A. RETURNS REGARDING PAYMENTS OF REMUNERATION FOR SERVICES AND DIRECT SALES.

"(a) RETURNS REGARDING REMUNERATION FOR SERVICES.—If—

"(1) any service-recipient engaged in a trade or business pays in the course of such trade or business during any calendar year remuneration to any person for services performed by such person, and

"(2) the aggregate of such remuneration paid to such person during such calendar year is $600 or more,

then the service-recipient shall make a return, according to the forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such payments and the name, address, and identification number of the recipient of such payments. For purposes of the preceding sentence, the term 'service-recipient' means the person for whom the service is performed.

"(b) DIRECT SALES OF $5,000 OR MORE.—

"(1) IN GENERAL.—If—

"(A) any person engaged in a trade or business in the course of such trade or business during any calendar year sells consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis which the Secretary prescribes by regulations, for resale (by the buyer or any other person) in the home, and

"(B) the aggregate amount of the sales to such buyer during such calendar year is $5,000 or more,

then such person shall make a return, according to the forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such sales and the name, address, and identification number of the buyer to whom such sales are made.

"(2) ELECTION NOT TO HAVE SUBSECTION APPLY.—

"(A) IN GENERAL.—Any person may elect, in such form and manner and at such time as the Secretary may prescribe by regulations, not to have this subsection apply with respect to returns required to be filed for any calendar year.

"(B) EFFECT OF ELECTION.—If any person makes an election under subparagraph (A) for any calendar year—

"(i) subsection (a) shall be applied with respect to such person for such calendar year by substituting '$50' for '$600', and

"(ii) the requirements of subsection (g) shall apply with respect to such person.

"(3) DEFINITIONS.—For purposes of paragraph (1)—

"(A) a transaction is on a buy-sell basis if the buyer performing the services is entitled to retain the difference between the price at which the buyer purchases the product and the price at which the buyer sells the product as part or all of the buyer's remuneration for the transaction, and

"(B) a transaction is on a deposit-commission basis if the buyer performing the services is entitled to retain the deposit paid by the consumer in connection with the transaction as part or all of the buyer's remuneration for the transaction.

"(c) CERTAIN SERVICES NOT INCLUDED.—No return shall be required under subsection (a) or (b) if a statement with respect to such services is required to be furnished under section 6051, 6052, or 6053.

"(d) APPLICATIONS TO GOVERNMENTAL UNITS.—In the case of any payment by the United States, a State or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, any return under this section shall be made by the officer or employee having control of the payment or appropriately designated for the purpose of making such return.

"(e) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS REQUIRED TO BE FURNISHED.—Every person required to make a return under subsection (a) or (b) shall furnish to each person whose name is required to be set forth in such return a written statement showing—

"(1) the name, address, and identification number of the person required to make such return, and

"(2) the aggregate amount of payments (or sales) to the person required to be shown on such return.

The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

"(f) RECIPIENT TO FURNISH NAME, ADDRESS, AND IDENTIFICATION NUMBER; INCLUSION ON RETURN.—

"(1) FURNISHING OF INFORMATION.—Any person with respect to whom a return or statement is required under this section to be made by another person shall furnish to such other person his name, address, and identification number at such time and in such manner as the Secretary may prescribe by regulations.

"(2) INCLUSION ON RETURN.—The person to whom an identification number is furnished under paragraph (1) shall include such number on any return which such person is required to file under this section and to which such identification number relates.

"(g) RETURNS OF DIRECT SELLERS WHO ELECT NOT TO HAVE SUBSECTION (b) APPLY.—

"(1) RETURNS.—If any person elects not to have subsection (b) apply with respect to any calendar year, such person shall make a return, according to the forms or regulations prescribed by the Secretary, setting forth the name and identification number of each buyer with respect to whom such person had aggregate sales described in subsection (b)(1) of $50 or more during the calendar year.

"(2) STATEMENTS TO BE FURNISHED TO PERSON WITH RESPECT TO WHOM INFORMATION IS REQUIRED TO BE FURNISHED.—Every person making a return under paragraph (1) shall furnish, not later than January 31 of the year following the year for which such return is made, to each person whose name is set forth in the return a written statement showing the name, address, and identification number of the person making such return.".

(b) PENALTIES.—

(1) IN GENERAL.—Subchapter A of chapter 68 (relating to additions to tax and additional amounts) is

amended by redesignating section 6660 as section 6661 and by inserting after section 6659 the following new section:

"SEC. 6660. ADDITIONAL AMOUNTS WITH RESPECT TO RETURNS REQUIRED BY SECTION 6041A.

"(a) FAILURE TO FILE AND INCORRECT FILINGS.—

"(1) IN GENERAL.—In the case of each failure—

"(A) to make the return required by subsection (a) or (b) of section 6041A, or to furnish the statement required by section 6041A(e), with respect to any person on the date prescribed therefor (determined with regard to any extension of time for filing), or

"(B) to include on any return or statement described in subparagraph (A) the entire amount required to be included,

there shall be paid (upon notice and demand by the Secretary and in the same manner as tax) with respect to each such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, by the person failing to make such return, to furnish such statement, or to include such amount, the amount determined under paragraph (2).

"(2) DETERMINATION OF AMOUNT.—

"(A) In general.—The amount determined under this paragraph shall be equal to the product of—

"(i) 1 percent for each month (or portion thereof) during which the failure continues (but not in excess of 5 percent), multiplied by

"(ii) the amount required to be included in the return or statement involved in such failure which was not included in such return or statement.

"(B) Minimum penalty.—In the case of a failure described in paragraph (1)(A), the amount determined under this paragraph shall not be less than $50.

"(C) Special rules for direct sellers.—In the case of a failure involving—

"(i) a return under section 6041A(b), or

"(ii) a statement under section 6041A(e) relating to such return,

subparagraph (A)(i) shall be applied by substituting '⅕ of 1 percent' for '1 percent' and '1 percent' for '5 percent'.

"(b) Surcharge in the Case of Multiple Violations.—

"(1) IN GENERAL.—There shall be added to any amount required to be paid under subsection (a) by any person with respect to any failure during any calendar year an amount equal to the percentage of such required amount determined in accordance with the following table:

"If the noncompliance percentage is—	The percentage is—
Over 10 but 20 or less	100
Over 20	200.

"(2) MIMIMUM NUMBER OF FAILURES BEFORE SURCHARGE IMPOSED.—No amount shall be added under paragraph (1) if the total number of failures by the person with respect to which an amount is required to be paid under subsection (a) for any calendar year is 10 or less.

"(3) NONCOMPLIANCE PERCENTAGE DEFINED.—For purposes of paragraph (1), the term 'noncompliance percentage' means a percentage equal to the ratio which the total number of failures of such person under subsection (a) for any calendar year bears to the total number of returns and statements which are required to be filed by such person under section 6041A during such calendar year.".

(2) PENALTY FOR FAILURE TO FILE SECTION 6041A(g) RETURN OR STATEMENT.—

(A) RETURNS.—Paragraph (2) of section 6652(a) (relating to returns relating to information at source payments, etc.) is amended to read as follows:

"(2) to make a return required by—

"(A) section 6041A(g) (relating to returns of direct sellers), or

"(B) section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance),".

(B) STATEMENTS.—Section 6678(1) (relating to failure to furnish certain statements) is amended—

(i) by inserting "6041A(g)(2)," after "6041(d),", and

(ii) by inserting "6041A(g)(1)," after "6041(a),".

(3) STATUTE OF LIMITATIONS.—Section 6501(c) (relating to exceptions on limitations on assessment and collection) is amended by adding at the end thereof the following new paragraph:

"(8) FAILURE TO FILE OR FURNISH CERTAIN INFORMATION RETURNS.—Except as provided in paragraphs (1), (2), and (4), in the case of a failure to file or furnish a return or statement described in section

6041A, the tax under section 6660 may not be assessed, or a proceeding in court for the collection of such tax may not be begun without assessment, more than 6 years after the last date for filing such return or statement (determined with regard to any extension of time for filing).".

(c) WITHHOLDING OF TAX IN CERTAIN CASES.—Section 3402 (relating to withholding at source) is amended by adding at the end thereof the following new subsection:

"(s) EXTENSION OF WITHHOLDING TO CERTAIN PERSONS WHERE IDENTIFYING NUMBER MISSING OR INCORRECT.—

"(1) IN GENERAL.—If, in the case of a return described in subsection (a) of section 6041A, a qualified payee with respect to such return—

"(A) fails to provide a required identification number, or

"(B) provides an incorrect required identification number,

then the person required to file such return shall deduct and withhold from the amount of any payment required to be included in such return a tax equal to 15 percent of such amount.

"(2) AMOUNTS AND PERIODS OF WITHHOLDING.—

"(A) FAILURE TO SUPPLY NUMBER.—In the case of a failure described in paragraph (1)(A), the tax under paragraph (1) shall be deducted and withheld on any amount which is paid during any period during which a required identification number has not been provided (or during the 7-day period following such period).

"(B) INCORRECT IDENTIFICATION NUMBER.—In the case of an incorrect required identification number described in paragraph (1)(B), the Secretary shall notify the qualified payee that the qualified payee has 60 days to correct such number. If the qualified payee fails to correct within such 60-day period, the tax under paragraph (1) shall be deducted and withheld on any amount which is paid during the period—

"(i) beginning on the 8th day after the date the Secretary notifies the payor that the payee has an incorrect required identification number, and

"(ii) ending on the 8th day after the date the Secretary notifies the payor that such number has been corrected.

"(C) MINIMUM AMOUNT REQUIRED BEFORE WITHHOLDING.—No amount shall be deducted and withheld with respect to any payment required to be included in any return described in paragraph (1) unless the aggregate amount of such payment and all previous payments during the period for which such return covers exceeds the minimum amount which must be paid before such return is required to be filed.

"(3) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) QUALIFIED PAYEE.—The term 'qualified payee' means any person with respect to whom a payment is made if such payment is required to be included in any return described in paragraph (1), other than—

"(i) the United States or any agency or instrumentality thereof,

"(ii) any State or political subdivision thereof,

"(iii) an organization which is exempt from taxation under section 501(a), or

"(iv) any foreign government or international organization.

"(B) REQUIRED IDENTIFICATION NUMBER.—The term 'required identification number' means an identifying number which is required to be furnished under section 6041A(f)(1).

"(C) Amounts for which withholding otherwise required.—No tax shall be deducted or withheld under this subsection with respect to any amount for which withholding is otherwise required by this title.

"(D) Application for numbers.—The Secretary shall prescribe regulations for exemptions from the tax imposed by paragraph (1) during periods during which a person is waiting for receipt of a required identification number.

"(E) Amounts required to be included in returns.—The determination as to whether a payment is required to be included in any return described in paragraph (1) shall be made without regard to any minimum amount which must be paid before a return is filed.

"(F) Coordination with other sections.—For purposes of this chapter (other than subsection (n)), and so much of subtitle F (other than section 7205) as relates to this chapter, payments of amounts to a qualified payee shall be treated as if they were wages paid by an employer to an employee.".

(d) APPLICATION WITH SECTION 6041.—Subsection (a) of section 6041 (relating to information at source) is amended by inserting "6041A (a) or (b)" before "6042(a)(1), 6044(a)(1)".

(e) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by inserting after the item relating to section 6041 the following new item:

"Sec. 6041A. Returns regarding payments of remuneration for services and direct sales.".

(2) The table of contents for subchapter A of chapter 68 is amended by striking out the last item and inserting in lieu thereof the following:

"Sec. 6660. Additional amounts with respect to returns required by section 6041A.
"Sec. 6661. Applicable rules.".

SEC. 4. EFFECTIVE DATES.

(a) ALTERNATIVE STANDARDS.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by section 2 shall apply to service performed after the earlier of—

(A) June 30, 1982, or

(B) the date of the enactment of this Act.

(2) TRANSITIONAL RULES.—

(A) WRITTEN CONTRACTS.—A written contract shall be required under section 3508(b)(4) of the Internal Revenue Code of 1954, as added by section 2, only with respect to services performed after December 31, 1982.

(B) Persons treated as employees.—If, with respect to service performed after the date determined under paragraph (1) and before January 1, 1983—

(i) the requirements of section 3508(b) of such Code, as so added, are met with respect to such service, and

(ii) the person performing such service was treated as an employee for purposes of such Code,

then the provisions of section 3508 of such Code, as so added, shall not apply with respect to such service.

(3) Exclusions from gross income.—The provisions of section 3508(e)(2) of such Code, as so added, shall apply to amounts paid after the date determined under paragraph (1).

(b) Reporting Requirements and Penalties.—

(1) In general.—The amendments made by subsections (a), (b)(1), (b)(3), (d), and (e) of section 3 shall apply to payments made after December 31, 1982.

(2) DIRECT SALES.—The provisions of section 6041A(b) of such Code (as added by section 3), and the amendments made by subsection (b)(2), shall apply to sales described in such section 6041A(b) made after December 31, 1983.

(c) WITHHOLDING.—The amendments made by section 3(c) shall apply to payments made after December 31, 1983.

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BACKGROUND ON CLASSIFICATION OF EMPLOYEES AND INDEPENDENT CONTRACTORS FOR TAX PURPOSES AND DESCRIPTION OF S. 2369

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Subcommittee on Oversight of the Internal Revenue Service has scheduled a public hearing on April 26, 1982, on S. 2369 (Senators Dole, Danforth, Boren, Wallop, Symms, Roth, Johnston, Kassebaum, Laxalt, Durenberger, and Hatch), relating to the tax status of independent contractors and tax compliance in the independent contractor sector.

This pamphlet, prepared in connection with the hearing, is divided into four parts. The first part is a brief summary of present law, background, and S. 2369. The second part is a discussion of present law. The third part discusses the background of the independent contractor/employee issue which led to legislative proposals. This part includes a discussion of the interim relief provided by the Revenue Act of 1978, and subsequently extended through June 30, 1982. The fourth part provides a description of the provisions of S. 2369.

I. SUMMARY

A. Present Law

Determination of status

Under present law, the classification of particular workers as employees or independent contractors for Federal income and employment tax purposes generally is determined under common law (i.e., nonstatutory) rules. Under the common law, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished," the relationship of employer and employee exists.

Social Security (FICA) taxes

For the calendar year 1982, employers and employees are required by the Federal Insurance Contributions Act to pay social security (FICA) taxes of 6.70 percent each on the first $32,400 of the employee's wages, for a maximum of $2,170.80 each and a maximum of $4,341.60 per employee.

Federal Unemployment Tax Act (FUTA) taxes

The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages up to $6,000 per year paid to an employee. However, a 2.7 percent credit normally is provided to employers who pay taxes under approved State unemployment compensation programs.

Federal income tax withholding

In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to an employee must withhold for each pay period a portion of the wages to satisfy all, or part, of the employee's Federal income tax liability.

Taxes on self-employed individuals

Compensation paid to individuals who are self-employed is not subject to Federal income tax withholding. Rather, self-employed individuals generally must make quarterly payments of estimated income and self-employment taxes directly to the Treasury.

For calendar year 1982, self-employed individuals with net self-employment earnings of $400 or more are required by the Self-Employment Contributions Act to pay social security (SECA) tax of 9.35 percent on earnings up to $32,400, for a maximum SECA tax of $3,029.40. Self-employed persons are not subject to FICA or FUTA taxes.

B. Background of Legislative Proposals

Increased IRS enforcement

In the late 1960's, the Internal Revenue Service increased audits of employment taxes. As a result, controversies developed between the

Service and some businesses concerning the proper classification of workers, including insurance agents, direct sellers, and real estate agents.

If a worker who had been treated as an independent contractor by a business were reclassified as an employee for past pay periods, the business would become liable for employment taxes (withholding, social security, and unemployment) with respect to the reclassified worker.

Revenue Act of 1978

The Revenue Act of 1978 provided interim relief for certain businesses involved in employment tax status controversies with the Service. In general, the Act terminated a business' potential liabilities for Federal income tax withholding, social security, and FUTA taxes in cases where the taxpayer had a reasonable basis for not treating workers as employees. In addition, the Act prohibited the issuance of Treasury regulations and revenue rulings on common law employment status.

The interim relief provisions of the 1978 Act, after extensions by Public Laws 96–167 and 96–541, are in effect through June 30, 1982.

C. S. 2369

The bill would provide a statutory "safe-harbor" test under which certain workers would be treated as independent contractors for Federal employment tax purposes; would impose specific information reporting requirements on persons who make payments to independent contractors; would provide new reporting requirements for persons who sell consumer products to buyers for resale in the home; and would provide new penalties for failures to report independent contractor payments. In addition, the bill would impose a withholding requirement in certain situations.

Safe-harbor test

An individual who satisfied the safe-harbor test would be classified as an independent contractor for Federal employment tax purposes. The safe-harbor requirements, each of which would have to be met for an individual to be classified as an independent contractor, relate to (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of tax responsibilities, and (5) the filing of required returns. An individual who did not meet all five safe-harbor requirements would be classified as an independent contractor or as an employee according to the common law rules.

Information reporting requirements

Under the bill, a specific provision would be added to the Code requiring information returns to be filed by a person for whom services are performed with respect to payments of remuneration, if aggregating $600 or more, to another person in the course of a trade or business. Also, direct sellers who make sales of certain consumer products aggregating $5,000 or more would be required either to file information returns with respect to sales, or to report payments of remuneration aggregating $50 or more. Direct sellers who elect to report payments of remuneration aggregating $50 or more also would be required to file a return which sets forth the name and identification number of each buyer with respect to whom they had aggregate sales of $50 or more.

Penalties and withholding

The bill would provide new penalties for failures to file information returns or to provide payees with statements. Moreover, withholding would be required in certain situations involving failures by payees to supply identification numbers.

The penalty for failure to file an information return or to furnish the recipient of the payment with a statement would be one percent per month (but not to exceed five percent) of the amount required to be included on the return, or on a statement to the recipient, that was not so included. In addition, a surcharge of 100 percent of the basic penalty amount would be imposed if the number of failures to file an information return, or to furnish statements, represents over 10 but not over 20 percent of the total number of returns and statements required to be made. The surcharge would be 200 percent if the number of failures exceeded 20 percent of the required number of returns and statements.

Finally, the bill would provide for withholding at a 15-percent rate if a worker failed to supply an identification number or supplied an incorrect number to another person who must file a return or furnish statements regarding payments for services or direct sales.

Effective dates

The safe-harbor test generally would apply to services performed after the earlier of June 30, 1982, or the date of enactment.

The new penalties and reporting requirements generally would apply to payments made after 1982; the reporting requirements for direct sales would apply to sales after 1983.

The new withholding provisions would apply to payments made after 1983.

II. PRESENT LAW

A. Classification of Individuals as Employees or Independent Contractors

Overview

Under present law, with certain statutory exceptions,[1] common law (i.e., nonstatutory) rules generally apply to determine whether particular workers are treated as employees or as independent contractors (self-employed persons) for purposes of Federal employment taxes. The determination of whether an employer-employee relationship exists is important because wages paid to employees generally are subject to social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and to unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). Compensation paid to independent contractors is subject to the tax on self-employment income (SECA), but not to FICA or FUTA taxes. (SECA is paid only by the self-employed individual.) In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

The Internal Revenue Code generally defines an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."[2] Under the common law test, an employer-employee relationship generally "exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[3] Thus, the most important factor under the common law is the degree of control, or right of control, which the employer has over the manner in which the worker is to perform services for the employer.

Consideration of various factors

In determining whether the necessary degree of control exists in order to find that an individual has common law employee status, the courts and the Internal Revenue Service ordinarily consider a number of factors. No single factor generally is dispositive of the issue.

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[1] Code sec. 3121(d)(3) (relating to statutory employees under the Federal Insurance Contributions Act) establishes four categories of statutory employees: certain agent-drivers or commission-drivers; full-time life insurance salespersons; home workers performing services on goods or materials; and full-time traveling or city salespersons. See also secs. 3306(i) and 1402(d).

[2] Code secs. 3121(d)(2) (FICA), 3306(i) (FUTA), and 1402(d) (SECA).

[3] See Treas. Reg. § 31.3401(c)-1(b).

Instead, all of the facts of a particular situation must be evaluated and weighed in light of the presence or absence of the various pertinent characteristics. The decision as to the weight to be accorded to any single factor necessarily depends upon both the activity under consideration and the purpose underlying the use of the factor as an element of the classification decision. Because of the particular attributes of a specific occupation, any single factor may be inapplicable.

List of factors

The 20 common law factors[4] generally considered in determining whether an employer-employee relationship exists are directed at the following questions:

1. Is the individual providing services required to comply with instructions concerning when, where, and how the work is to be done?
2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method?
3. Are the services performed by the individual integrated into the business' operations?
4. Must the services be rendered personally?
5. Does the business hire, supervise, or pay assistants to help the individual performing services under contract?
6. Is the relationship between the individual and the person for whom he or she performs services a continuing relationship?
7. Who sets the hours of work?
8. Is the individual required to devote full time to the person for whom he or she performs services?
9. Does the individual perform work on another's business premises?
10. Who directs the order or sequence in which the work must be done?
11. Are regular oral or written reports required?
12. What is the method of payment—hourly, weekly, commission, or by the job?
13. Are business or traveling expenses reimbursed?
14. Who furnishes tools and materials necessary for the provision of services?
15. Does the individual performing services have a significant investment in facilities used to perform services?
16. Can the individual providing services realize both a profit or loss?
17. Can the individual providing services work for a number of firms at the same time?
18. Does the individual make his or her services available to the general public?
19. Is the individual providing services subject to dismissal for reasons other than nonperformance of contract specifications?
20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?

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[4] The common law factors are set forth in the following Internal Revenue Service documents: Exhibit 4640-1, Internal Revenue Manual 8463 and Chapter 2, "Employer-Employee Relationships," Training 3142-01 (Rev. 5-71).

B. Differences in Tax Liabilities Resulting From Classification as an Employee or Independent Contractor

Employees

FICA tax

The Federal Insurance Contributions Act (Code secs. 3101–3126) imposes two taxes on employers and two taxes on employees. These taxes are used to finance the payment of old-age, survivor, and disability insurance benefits payable under Title II of the Social Security Act and to finance the costs of hospital and related post-hospital services incurred by social security beneficiaries as provided in Part A of Title XVIII of the Social Security Act (Medicare).

The FICA tax base is measured by the amount of wages received with respect to employment. The term "wages" generally means all remuneration for employment unless specifically excepted. (Treas. Reg. § 31.3121(a)–1). The term "employment" includes all non-exempt service, of whatever nature, performed by an employee for the person employing him or her (Treas. Reg. § 31.3121(b)–3). An employer must withhold the employee's share of FICA taxes from the employee's wages when paid (secs. 3102 (a) and (b)).

For calendar year 1982, employers and employees are each required to pay FICA tax of 6.70 percent on the first $32,400 of an employee's wages (for a maximum of $2,170.80 each, or a total maximum of $4,341.60 per employee).[5]

FUTA tax

The Federal Unemployment Tax Act (Code secs. 3301–3311) imposes a tax on employers. FUTA tax revenues are used to pay the administrative costs of Federal and State unemployment compensation programs and to help finance the payment of benefits to unemployed insured workers.

The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages of up to $6,000 a year paid to an employee (sec. 3301). However, a 2.7 percent credit against Federal tax liability normally is provided to employers who pay State taxes under an approved State unemployment compensation program (sec. 3302). For employers in States which have an approved unemployment compensation program, the effective FUTA tax rate normally is 0.7 percent (a maximum of $42 per employee).

The FUTA tax generally applies to an employer who employs one or more employees in covered employment for at least 20 weeks in the current or preceding calendar year or who pays wages of $1,500 or more during any calendar quarter of the current or preceding calendar year. In addition, certain agricultural labor and domestic services constitute covered employment for purposes of the FUTA tax.

Income tax withholding

In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to individual employees must withhold a portion of the wages to satisfy all, or part, of the employee's Federal income tax liability (sec. 3402).

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[5] The current FICA tax rate is scheduled to increase to 7.05 percent in 1985, 7.15 percent in 1986, and 7.65 percent in 1990.

The definitions relating to employment for purposes of income tax withholding are similar to the FICA and FUTA definitions. The term "employer" generally is defined as any person for whom an individual performs any service as an employee. An "employee" is an individual who performs services subject to the control of an employer, both as to what shall be done and how (Treas. Reg. § 31.3401(c)-1). The term "wages" is defined generally as all remuneration, unless specifically excluded, for services performed by an employee for the employer, including the cash value of all remuneration paid other than in cash (sec. 3401(a)).

Self-employed individuals

SECA tax

The Self-Employment Contributions Act (Code secs, 1401-1403) imposes two taxes on the self-employed. The SECA taxes finance the cost of old-age, survivors, and disability insurance benefits payable under Title II of the Social Security Act, as well as the cost of hospital and related post-hospital services incurred by social security beneficiaries (as provided for in Part A of Title XVIII of the Social Security Act).

The taxes levied under SECA, and the amount of income which may be credited toward benefits or insurance coverage, are based on an individual's self-employment income. The term "net earnings from self-employment" generally means the sum of: (1) the gross income derived by an individual from any trade or business carried on by such individual, less allowable deductions attributable to such trade or business, and (2) the individual's distributive share of the ordinary net income or loss from any trade or business carried on by a partnership of which the individual is a member (Code sec. 1402(a)).

The term "self-employment income" excludes net earnings from self-employment in any taxable year if such earnings are less than $400 (Code sec. 1402(b)).

For calendar year 1982, a self-employed individual must pay SECA tax at a rate of 9.35 percent on net earnings of up to $32,400 (for a maximum SECA tax of $3,029.40).[6] Although the SECA tax rate (9.35 percent) is higher than the rate applicable to an employee's share of FICA tax (6.70 percent), it is lower than the combined employer-employee FICA rate (13.4 percent). An individual with $400 or more of net earnings from self-employment for the year must file a return showing the self-employment tax due (sec. 6017).

Income tax withholding

There is no Federal income tax withholding with respect to self-employment income. A self-employed individual may be required to file a declaration of estimated income tax if his or her gross income for the year reasonably can be expected to include more than $500 from sources other than wages (sec. 6015). However, no declaration is required if the amount of estimated tax for the year is less than $200.[7]

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[6] The SECA tax rate currently is scheduled to increase to a rate of 9.90 percent in 1985, 10 percent in 1986, and 10.75 percent in 1990.

[7] The estimated tax payment threshold is scheduled to increase in annual increments of $100 until it reaches $500 for 1985 and subsequent years.

C. Information Reporting

Under present law, persons engaged in a trade or business generally must file information returns with respect to payments to another person aggregating $600 or more in the taxable year (sec. 6041(a)).[8] This reporting obligation, subject to various exceptions, applies to payments (whether made in cash or property) of salaries, wages, commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income.

These information returns, which are required to be filed on an annual basis, generally must contain the name, address, and identification number of the recipient of the payment, and the aggregate amount paid (secs. 6041(a) and 6109(a)). Recipients covered by this reporting requirement must furnish their name and address to the payor (sec. 6041(c)).

In addition, a payor required to file such an information return with the IRS also must provide the recipient with a statement which shows the payor's name, address, and identification number and the aggregate amount of payments made to the recipient (sec. 6041(d), effective for returns required after 1981).

The penalty for failure to file an information return, or to provide the recipient with a statement, is $10 for each failure, with a maximum aggregate penalty of $25,000 for any one calendar year (sec. 6652(a) and 6678).

D. Judicial Remedies in Employment Tax Disputes

The U.S. Tax Court does not have jurisdiction over disputes involving employment taxes (sec. 6211). Thus, after assessment of an employment tax, the only judicial remedy ordinarily available to a taxpayer is payment of the tax, followed by a refund suit in a U.S. district court or the U.S. Court of Claims (after September, 1982, the U.S. Claims Court).

Since employment taxes are "divisible,"[9] however, a taxpayer generally may challenge an employment tax assessment merely by paying the tax for one worker for one quarter, and then suing for a refund of that tax.[10] Generally, such a refund suit also would include a claim for an abatement of the unpaid. but previously assessed, taxes. The Service ordinarily would counterclaim in the litigation for the balance of the assessment. This procedure allows a resolution of employment tax issues without payment of the full amount of the employment tax assessment prior to litigation.

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[8] Generally, these returns are intended to inform the Internal Revenue Service that specified items have been disbursed by a payor. This information may aid the Service in determining whether the recipient of the item covered by the return has treated it properly for tax purposes. The obligation to file information returns is in addition to the requirement to file returns which reflect the filer's primary liability for the payment of a tax.

[9] That is, they are predicated on the employment of an individual for a calendar quarter.

[10] See, e.g., *Marvel* v. *U.S.*, 548 F. 2d 295 (10th Cir. 1977).

III. BACKGROUND OF LEGISLATIVE PROPOSALS

A. Increase in Controversies Over Employment Tax Status

As a result of increased employment tax audits in the late 1960's, controversies developed between some businesses and the Internal Revenue Service as to whether certain groups or types of workers who had long been treated as independent contractors should be classified as employees for Federal tax purposes. If such workers were classified as employees for past pay periods, then the business would become liable for previously unpaid employment taxes—i.e., social security (FICA) taxes, unemployment (FUTA) taxes, and Federal income tax withholding—for all open years.

Many of these businesses argued that proposed classifications of certain workers as employees involved changes of positions previously taken by the Service in interpreting how the common law rules applied to their workers or industry. One example of what many taxpayers believed to be a controversial change of position involved two 1976 revenue rulings dealing with real estate salespersons. Rev. Rul. 76-136[1] held that securities and real estate salespersons, remunerated solely on a commission basis, are not employees where, although provided office facilities and supplies, they are required to pay their own expenses and are not required to work under supervision, attend meetings, or work specified hours. Rev. Rul. 76-137[2] held that real estate salespersons, remunerated solely on a commission basis, are employees of a real estate company where they are registered by the State in the name of the company, may receive a draw against commissions, may be required to submit reports and attend sales meetings, and may be discharged for failure to sell a minimum amount of property. Both of these rulings were revoked in 1978.[3]

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[1] 1976-1 C.B. 312.
[2] 1976-1 C.B. 313.
[3] Rev. Rul. 78-365, 1978-2 C.B. 254.

B. Consequences of Reclassifying Workers

Overview

If a worker who has been treated as an independent contractor is determined retroactively to be an employee, four general tax consequences may follow:

(1) The business whose workers are reclassified may be assessed FICA and FUTA employment taxes for years for which such assessment is not barred by the statute of limitations.

(2) Overpayments of income taxes may occur if the business is required to pay amounts as withholding of employee income tax liabilities with respect to which workers already had paid income tax (through estimated tax payments or with their returns).

(3) Overpayments of social security taxes may occur if the business is required to pay FICA taxes with respect to workers who already had paid self-employment (SECA) taxes.

(4) The retirement plan of the business may be disqualified.

Withholding

If a worker reclassification occurs, the employer generally is responsible for all employment tax liabilities (income tax withholding, both the employer's and the employee's share of FICA taxes, and the FUTA taxes) with respect to the reclassified worker. Federal income tax withholding assessments may be adjusted if the reclassified worker pays (or has paid) the proper amount of income tax (sec. 3402(d)). However, the employer generally is not relieved of any applicable penalties or additions to tax for failure to timely pay over amounts as withholding.

FICA tax

The reclassified worker's share of FICA tax often is not adjusted to reflect the amount of SECA tax already paid on the same income. This is because present law (sec. 6521) authorizes a FICA–SECA offset only if the worker who has been reclassified as an employee is prevented from filing for a refund of the SECA tax paid in error. This may result in the double collection of the employee's portion of social security tax: (1) once from the business as the FICA tax it initially failed to withhold from the reclassified employee, and (2) once from the employee as the SECA tax previously paid in error, if the employee could obtain a SECA tax refund but fails to do so.

Retirement plans

The reclassification also may have adverse effects on self-employed (H.R. 10) retirement plans. If the individual previously had received a determination from the Service that he or she was an independent contractor and then was reclassified as an employee, the retirement plan would be frozen and any future contributions to the plan would not be exempt from tax. If the individual previously had not received such a determination, the plan could be disqualified and all amounts in the plan (previous contributions plus income) then would be taxable. Furthermore, if an employer previously had established a qualified retirement plan for some workers whose status as employees was recognized, and the Service subsequently reclassified as employees additional workers whom the employer had been treating as independent contractors, the previously qualified retirement plan for the employees could be disqualified for failure to meet the minimum coverage requirements (sec. 410(b)).

C. Tax Reform Act of 1976

The conferees on the Tax Reform Act of 1976 requested that, until completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying workers for tax purposes, the Internal Revenue Service should not apply "any changed position or any newly stated position which is inconsistent with a prior general audit position in this general subject area to past, as opposed to future, taxable years * * *.[4] The Joint Committee on Taxation previously had asked the General Accounting Office (GAO) to examine the Service's administration of employment taxes, including the classification of individuals as employees or independent contractors.

D. GAO Recommendations

In its 1977 report, the GAO concluded that the principal problem with regard to classification of individuals for employment tax purposes is the uncertainty in the interpretation and application of the governing common law rules.[5] Based on its survey of industries and workers, the GAO concluded that uncertainty and controversies most frequently arise in cases in which an individual operates a business that is separate from, or subordinate to, another business that the Service may consider to be the individual's employer.[6]

The GAO recommended that the owner of a separate business entity should be excluded from the common law definition of employee if the owner:

(1) has a separate set of books and records which reflect items of income and expenses of the trade or business;

(2) has the risk of suffering a loss and the opportunity of making a profit;

(3) has a principal place of business other than at a place of business furnished by the persons for whom the owner performs or furnishes services; and

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[4] House Rpt. No. 94-1515, 94th Cong., 2d Sess. (1976), at 489. The Joint Committee staff report, "Issues in the Classification of Individuals as Employees or Independent Contractors" (JCS-5-79, February 28, 1979), provided an explanation of the common law rules governing employment status, a description of the source of employment tax status controversies, and a review of prior Congressional action. The report also discussed some of the interests and concerns of the parties involved in employment tax controversies, and analyzed how present law treats those parties and how several alternatives might affect them.

[5] Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," GGD-77-88, November 21, 1977.

[6] Examples of such cases would include sales through an independent agency of another party's products, or the subcontracting of work from a prime contractor.

(4) holds himself out in his own name as self-employed or makes his own services generally available to the public.

An employer-employee relationship would exist, under the GAO recommendations, if an individual met fewer than three of these tests. If an individual met three of the four tests, the common law criteria would be used to determine employment status. The GAO further recommended that, absent fraud, the Service should be prevented from making a retroactive employee determination if the business annually obtains from the workers it classifies as self-employed signed certificates stating that they meet the separate business entity criteria and the business annually provides the Service with the names and employer identification or social security numbers of all certificate signers.

In order to alleviate the problem of double collection of social security taxes on the same income, the GAO recommended that the Service be authorized to reduce the employee portion of FICA taxes assessed against employers by an appropriate portion of the self-employment taxes (SECA) paid by reclassified workers for the open years.

E. Revenue Act of 1978

General rules

During consideration of the Revenue Act of 1978, the Congress decided that it would be appropriate to provide interim relief to taxpayers involved in employment tax status controversies with the Service until the Congress had time to resolve the complex issues involved in that area. Section 530 of the 1978 Act provided such relief by: (1) terminating certain employment tax liabilities for periods ending before January 1, 1979; (2) allowing taxpayers who had a reasonable basis for not treating workers as employees in the past to continue such treatment for periods ending before January 1, 1980, without incurring employment tax liabilities; and (3) prohibiting the issuance, prior to 1980, of regulations and revenue rulings on common law employment status.

The temporary prohibitions on employment tax status reclassifications and on the issuance of new rulings or regulations were extended, by P.L. 96-167, through December 31, 1980. These prohibitions were again extended, by P.L. 96-541, through June 30, 1982.

Prohibition on reclassifications

The 1978 Act allows a business to treat its workers as independent contractors (through June 30, 1982, pursuant to the extensions) unless there is no reasonable basis for that treatment. The taxpayer must file all Federal tax returns (including information returns) that are required to be filed with respect to workers whose status is at issue on a basis consistent with the taxpayer's treatment of the workers as independent contractors.

The 1978 Act established three alternative statutory standards which, if met, provide a reasonable basis for treating a worker as an independent contractor. The first standard is met if the taxpayer's treatment of a worker as an independent contractor is due to reasonable reliance upon judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling issued to the taxpayer. The second standard can be met by showing reasonable reliance upon a past IRS audit of the taxpayer. The third statutory method for establishing a reasonable basis for treating a worker as an independent contractor is to show that such treatment coincides with a long-standing, recognized practice of a significant segment of the industry in which the worker whose status is at issue is engaged.

The three statutory methods for fulfilling the Act's requirement that the taxpayer have a reasonable basis for treating a worker as an independent contractor are not exclusive. That is, a taxpayer may be able to demonstrate a reasonable basis for treating a worker as an independent contractor in some other manner.

Prohibition on rulings and regulations

The Act prohibits the Service from issuing any regulation or revenue ruling that classifies individuals for purposes of employment taxes under interpretations of the common law. However, this prohibition does not apply to the issuance of private letter rulings requested by taxpayers, or of regulations or revenue rulings that do not involve application of common law standards.

IV. DESCRIPTION OF S. 2369

A. Overview

S. 2369 (The Independent Contractor Tax Classification and Compliance Act of 1982) would provide a statutory "safe-harbor" test under which certain workers are treated as independent contractors for Federal employment tax purposes; would impose certain information reporting requirements on persons who make payments to independent contractors; would provide new reporting requirements for persons who sell consumer products to buyers for resale in the home; and would provide new penalties for failures to report independent contractor payments, or to provide required statements to independent contractors. Moreover, the bill would impose withholding in certain situations where workers fail to provide identification numbers.

B. Safe-Harbor Rule

Five requirements

The bill would establish a safe-harbor test that, if satisfied, results in the classification of an individual as an independent contractor for Federal employment tax purposes. The safe-harbor test would have five requirements, all of which would have to be met for an individual to be treated as an independent contractor under the bill. These requirements relate to (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of tax responsibilities, and (5) the filing of required returns.

(*1*) *Control of hours worked*

The first requirement would be met if the worker controls both the aggregate number of hours worked and also substantially all of the scheduling of those hours. In determining whether an individual controls the scheduling of hours worked, limitations on scheduling would be disregarded if they result from government regulatory requirements, from operating procedures and specifications which have been imposed on the person for whom service is performed (the "service-recipient") pursuant to contract with another party, from coordination of the performance of the service (by persons other than the service-recipient) with the performance of other services, or the control of access to any premises by the service-recipient if the individual controls the scheduling of hours when access is granted.

(*2*) *Place of business*

The second requirement would be met if no principal place of business of the worker with respect to the service was provided by the service-recipient. (Accordingly, the requirement would be met if the individual had no principal place of business with respect to the service.) However, the fact that the service-recipient provided a principal place of business with respect to the service would not cause the individual to fail this requirement if the individual paid a fair rental to the service-recipient.

A special rule would provide that even though a place of business was provided by the service-recipient, it would not be treated as a principal place of business if substantially all the service were performed at some other place of business that is not provided by the service-recipient.

(3) *Investment or income fluctuation*

The third requirement could be met in either of two ways.

First, the investment or income fluctuation requirement would be met if the worker had a qualifying investment in tangible assets which the individual used in connection with the performance of the service. To qualify, the assets would have to be of significant value in the performance of the service, and the individual's investment in the assets would have to be substantial in light of the nature and amount of the remuneration received for the service. For purposes of this asset investment test, an investment in a vehicle that is used primarily to transport the individual (and any tools, samples, or similar items) would not be taken into account.

Alternatively, this third requirement would be met if the worker risked income fluctuations because more than 90 percent of the remuneration for the performance of the service was directly related to sales or other output (including the performance of services, but not including piecework) rather than to the number of hours worked.

(4) *Written contract and notice of tax responsibilities*

The fourth requirement would be met if both (a) the individual performed services pursuant to a written contract (entered into before performance of the service) which expressly provided that the individual would not be treated as an employee for purposes of employment taxes, income tax withholding, and certain employee benefit provisions, and (b) the individual was given written notice (in the contract, or at the time the contract was executed) of his or her tax responsibilities for payment of Federal self-employment and income taxes.

The bill provides a special rule for written contracts entered into before January 1, 1983. A pre-1983 written contract would meet the fourth safe-harbor requirement (written contract and notice) if both (1) the contract clearly indicated that the individual was not an employee (e.g., by specifying the individual is an independent contractor) and (2) the notice of tax responsibilities was provided prior to January 1, 1983.

(5) *Filing of required returns*

This requirement would be met if the service-recipient filed all required information returns with respect to payments made to the worker, unless the failure to do so was due to reasonable cause and not to willful neglect.

Effect on other laws

A relationship which did not satisfy the safe-harbor test under the bill would be classified under common law rules, as if the safe-harbor test had not been enacted.

Qualification as an independent contractor under the safe-harbor test of the bill generally would create no inference with respect to status under provisions of law other than Federal employment tax provisions. However, individuals who qualified as independent contractors under the safe-harbor test for employment tax purposes could not be treated as employees for purposes of tax provisions relating to employer-provided group-term life insurance, death benefits, accident and health benefits, group legal services, educational assistance plans, dependent care assistance programs, and pension, profit-sharing, stock bonus, or annuity plans. This latter rule would not apply in the case of certain pre-1983 services (see discussion of Effective Dates, below).

Nonapplication to certain individuals

The safe-harbor test would not apply to certain agent-drivers or commission-drivers, full-time life insurance salespersons, certain home workers, and full-time traveling or city salespersons who generally are classified under present statutory law as employees for FICA tax purposes.

C. Information Reporting Requirements

Payments of remuneration

The bill would provide a separate Code provision specifically dealing with payments of remuneration for services. Under the bill, a service-recipient engaged in a trade or business who made payments of remuneration in the course of that trade or business to any person for services performed would have to file with the Internal Revenue Service an information return reporting such payments (and the name, address, and identification number of the recipient) if the remuneration paid to the person during the calendar year was $600 or more. Also, the person receiving such payments would have to be furnished with a statement setting forth the name, address, and identification number of the service-recipient, and the aggregate amount of payments made to him or her during the year.

Direct sales

The bill also would provide a new information reporting requirement for certain "direct sellers." The new requirement would apply where a person, in the course of a trade or business, sells consumer products aggregating $5,000 or more to a buyer for resale (by the buyer or any other person) in the home on a buy-sell basis, a deposit-commission basis, or any similar basis as specified in Treasury regulations.[1]

In general, the direct seller would have to file an information return stating the aggregate amount of the sales to such buyer and the name, address, and identification number of the buyer to whom the sales were made. The direct seller also would have to furnish the buyer with a statement setting forth the name, address, and identification number of the seller, and the aggregate amount of sales to the buyer.

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[1] A transaction would be on a buy-sell basis if the buyer performing the services were entitled to retain the difference between the price at which he or she purchased the product and the price at which the product was sold as part or all of the buyer's remuneration for the transaction. A transaction would be on a deposit-commission basis if the buyer performing the services were entitled to retain the deposit paid by the consumer in connection with the transaction as part or all of his or her remuneration for the transaction.

In lieu of so reporting sales of consumer products for resale, a direct seller could elect to be subject, instead, to the bill's reporting requirements for payments of remuneration for services. However, if a direct seller made the election, then the threshold for such reporting would be payments aggregating $50 or more in the calendar year (rather than the generally applicable threshold of $600 or more). Moreover, direct sellers who elected to report payments of remuneration aggregating $50 or more also would be required to file a return setting forth the name and identification number of each buyer with respect to whom they had aggregate sales of $50 or more.

D. Penalties for Failure To Provide Information

Basic penalty

The bill would add a new penalty for noncompliance with the requirements for filing information returns or furnishing statements regarding payments for services or direct sales. The new penalty would be imposed if a person (1) failed to make a required return regarding payments made to another person for services rendered by such other person or regarding direct sales to another person; (2) failed to furnish a statement to such other person regarding such return; or (3) failed to include on any return or statement the entire amount required to be included.

For each failure with respect to an information return or statement regarding payments for services, the penalty would be one percent per month while the failure continued (but not to exceed five percent) of the amount required to be included on the return or statement but not so included. In the case of each failure regarding information returns and statements on direct sales, the penalty would be one-fifth of one percent per month, but not to exceed one percent of the amount not included. The minimum penalty for either type of case (payments for services or direct sales) would be $50. This penalty would not apply if the failure in either type of case was due to reasonable cause and not due to willful neglect.

Penalty surcharge

In addition to the basic penalty described above, the bill would impose a penalty surcharge in the case of multiple violations.

A surcharge of 100 percent of the basic penalty amount would be imposed if the number of failures to file an information return or furnish a statement for a calendar year represented over 10 but not over 20 percent of the total number of returns and statements required to be made by such person for that year. The surcharge would be 200 percent of the basic penalty if the number of such failures was more than 20 percent of the number of returns and statements required. However, no surcharge would apply if the number of such failures for any calendar year was 10 or less, or if the percentage of failures for such year was 10 percent or less.

Statute of limitations exception

The bill would provide a new exception to the general statute of limitations provisions with respect to failures to file information returns or furnish statements of payments for services and direct sales. Under the bill, the Internal Revenue Service generally could not assess the new penalty and surcharge unless it was assessed, or a proceeding to collect it had begun, within six years after the last date (with extensions for filing) for filing the return or statement.

Withholding in certain cases

The bill would provide for withholding of tax at source at a rate of 15 percent if a payee failed to supply an identification number or supplied an incorrect identification number to a person who had to file a return or furnish statements regarding payments for services or direct sales.

If the identification number was not supplied, the payor-filer would be required to begin withholding when aggregate payments to the payee for the calendar year first exceed any threshold requiring the reporting of such payments. If the identification number was incorrect, the payor would be required to start withholding on notice from the Internal Revenue Service that the payee had failed to supply the correct identification number within 60 days after being notified by the Service to do so. Such withholding generally would continue as long as the payee failed to supply or correct his or her identification number.

E. Effective Dates

The safe-harbor test of the bill generally would apply to services performed after the earlier of June 30, 1982, or the date of enactment. However, the written contract requirement would apply only with respect to services performed after December 31, 1982. Furthermore, with respect to services performed after the date of enactment (or after June 30, 1982) and before January 1, 1983, if an individual performing services were treated as an employee, then the safe-harbor test would not apply to those services.

The new information reporting requirements, and penalties for failure to provide information, generally would apply to payments made after December 31, 1982. However, the new reporting requirements for direct sellers would apply only to sales after December 31, 1983.

The new withholding provisions (for failure by a payee to supply a correct identification number) would be effective for payments made after December 31, 1983.

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Senator **Grassley**. I would like to call this hearing of the Subcommittee on Oversight of the Internal Revenue Service to order. The topic of our hearing today is the tax treatment of independent contractors. The specific piece of legislation that we are taking testimony on is Senator Dole's proposed solution to that problem, S. 2369.

The problem of defining independent contractors for tax purposes has long plagued the IRS, employers, and workers. Concerned about the loss of employment taxes, the IRS increased audits in the late 1960's. The Service's efforts were aimed at reclassifying insurance agents, direct sellers and real estate agents, and others as employees rather than independent contractors. The effect of this change was to make employers liable for unpaid employment taxes, including wage withholding, social security, and unemployment taxes.

During the 1970's, the IRS resumed their enforcement effort, which led to the congressional enactment of the Revenue Act of 1978, which included a provision terminating an employer's back tax liability if the employer had any reasonable basis for treating his workers as independent contractors. This appropriation's rider also prohibited the issuance of any regulations or revenue rulings on the common law employment status. This moratorium has been extended numerous times and expires June 30, 1982.

Senator Dole has introduced legislation which defines independent contractors for tax purposes by creating a five-factor safe harbor test which workers must meet to be considered independent contractors for tax purposes. If employees do not meet all five factors, they may still be considered independent contractors for tax purposes if they meet the traditional common law test. This approach has merit because the safe harbor gives the employer and employee certainty about the tax treatment of their relationship. Retention of the common law test injects fairness into the classification process, insuring that no independent contractor under common law will lose his tax status merely because Senator Dole's bill is passed. Senator Dole's bill also includes new information reporting requirements and the new penalties for those who fail to comply.

Senator Dole deserves great praise for his legislative initiative. He has managed to forge a compromise among groups with widely divergent interests. This compromise resulting in S. 2369 has been a long and difficult battle. All affected parties are to be complimented for their self-discipline in achieving this goal. Senator Dole's leadership and the hard work of his staff have made this legislation possible. Because this is such a fine measure, I'd like to announce my cosponsorship of it.

Before we hear any comments from our witnesses, I'd like to ask Chairman Dole if he has any opening statements that he would like to make at this time.

STATEMENT OF HON. ROBERT DOLE OF KANSAS

Senator **Dole**. Thank you, Mr. Chairman. You are doing such a good job for me that maybe I shouldn't say anything. But I appreciate it very much. I do have a written statement I would like to have made a part of the record. Also a summary of the bill, a sort of a section-by-section analysis of the legislation. We have some outstanding witnesses testifying this afternoon. I do want to thank the chairman. And I welcome his cosponsorship. We have seven other members of the Finance Committee as cosponsors. It's not a partisan bill in any sense of the word.

We believe that with the expiration date of June 30 not far away that it is important that we move on this legislation very quickly. And as Senator Grassley has pointed out, this has been around for a long time. I have been involved in it, one way or another, over the past several years. Hopefully, we can now move to bring some of the groups together who have different views. But I think we are moving in the right direction. I will be interested to hear the witnesses; particularly, the Treasury witnesses and the Government Accounting Office, to see what they think of this effort. And, of course, we are pleased to have Congressman Stark here also.

So I just ask that my statement and the section-by-section analysis be included in the record.

Senator GRASSLEY. At this point, then, it's my pleasure to call the first witness, Congressman Pete Stark, Representative for the State of California, who is an active member of the Ways and Means Committee in the U.S. House of Representatives, a person whom I got well acquainted with during the 6 years that I was in the House of Representatives. We welcome you to the Finance Committee, and appreciate your testimony on this particular subject. Would you proceed, please?

STATEMENT OF HON. FORTNEY H. (PETE) STARK, A REPRESENTATIVE, STATE OF CALIFORNIA

Congressman STARK. Thank you, Senator, and Senator Dole. I, too, want to add my commendation to the proposal which you have introduced and the approach that you are taking to resolve the problem of the independent contractors and the tax proposals attended to their industry. As you know, the Select Revenue Measures Subcommittee, which I chair, has been extensively involved in this issue during the last two Congresses. I am sure that we both share a desire to see this issue finally resolved.

I ask that my prepared statement be made a part of the record, which I am sure that you can glance through much more quickly than I can read it.

And just to paraphrase some of the issues, I would also ask that a report from Mark McConaghy on the Joint Committee of Taxation, which summarizes a lot of the statistical data that I will refer to, be made part of the record. And that excerpts from a tape recording which may have started all this and may be of interest to the committee, be made part of the record.

Senator GRASSLEY. Without objection, so ordered.

[The prepared statement and other documents follow:]

TESTIMONY OF HON. FORTNEY H. (PETE) STARK

Senator Grassley, Members of the Subcommittee, it is a pleasure to appear here today as your Oversight Subcommmttee reviews independent contractor tax proposals. As you know, the Select Revenue Measures Subcommittee, which I chair, has been extensively involved in this issue during the past two Congresses. I am sure that we both share a desire to see this issue finally resolved.

I am appearing here today not to rehash the entire range of independent contractor issues, but rather to bring to the attention of this Subcommittee a particular compliance problem which has recently been the subject of hearings in my Subcommittee.

On April 19, the Subcommittee on Select Revenue Measures held a hearing to determine to what extent certain self-employed individuals, particularly those involved in certain selling activities, were over-stating deductions in an attempt to convert personal deductible expenses into deductible business expenses. This abuse is not one of concealing income, about which we have recently heard so much, but rather one of converting personal expenses such as those for home, meals, travel, and entertainment into business expenses and then using these so-called business deductions to lower taxes on wages or some other source of income.

This issue came to my attention when our Subcommittee obtained a copy of a tape cassette recording of a former IRS agent speaking to a group of direct sellers. The speaker encouraged the direct seller, among others, to:

1. Hire their children as employees and deduct their salary noting that even a three year old can dust shelves.
2. Make a trip to a relative in Florida deductible by sending a letter saying that you want to discuss a wonderful business opportunity.
3. Convert every meal eaten out into a deduction by mentioning one's direct selling operation during the course of the meal.
4. Buy products from the sponsoring company and either use these products one self, or give them as Christmas or birthday gifts and then deduct them as promotional items.

This tape, exhorting sellers of consumer products in the home to engage in a massive manipulation of their personal affairs to manufacture deductible business expenses, has been circulated nationwide. In fact, the Internal Revenue Service has been investigating this problem and feels that the problem may be growing in size and impact on the Treasury, although audits have not progressed far enough to give an indication of the scope of magnitude of the problem nationwide.

I requested the staff of the Joint Committee on Taxation to review a selected sample of actual returns of this type which had been pulled for audit. While all returns showed deductions far in excess of business income, some of the returns were truly astonishing. One return showed $341 in gross sales and over $8,000 in business deductions. Another showed $471 in gross sales and over $11,000 in business deductions. The largest areas of deductions included automobiles, demos and samples, entertainment expenses, and tapes and recorders. The average tax loss to the Federal Government was between $2,000 and $3,000 per return.

I think the record of our Subcommittee's hearing demonstrates that we need to take a serious look at the problem of excess deductions as part of the overall independent contractor issue. I commend the work that you are doing in the compliance area, Senator Grassley, particularly the bill you have co-sponsored with Senator Dole, S. 2198, the Taxpayer Compliance Improvement Act of 1982.

It is my hope that we can work together toward fashioning some approach to what I consider to be a very serious and growing problem of over-stated deductions. It appears to me that this problem is sufficiently important that it best be addressed without delay.

I ask that the report of the staff of the Joint Committee on Taxation to me in connection with the hearing held by the Subcommittee on Select Revenue Measures on April 19 be made part of the record of these hearings.

Thank you for this opportunity to appear before the Subcommittee today and I look forward to working with you on this important issue in the future.

EXCERPTS FROM TAX TAPE

I'm talking about the areas where you're already spending money expenses you already have and converting those personal expenses into business tax deductions. How are we able to do this? Well simply since we are each independent businessmen or women we can deduct expenses for promoting or developing our business.

Taking that one step further, let's say someone buys a Seville and you're talking about a $24,000 car. Now you're talking about $2,400 tax credit just for buying that car. Nice way to get the government to make your downpayment. You know through this business you can literally convert your car to 100 percent business use.

Since all of your friends and relatives are either potential prospects or clients or currently prospects or clients. Almost any time you go out with a friend or relative you can convert it to a business expense if you'll talk business during part of the evening.

How many people do you give birthday gifts to? How many people do you give Christmas gifts, or Hanukkah gifts, wedding gifts, baby showers? If you give them something that you purchase through this business—and representing over 350 manufacturers that gives you alot of items to choose from—if you give them something from this business and you want them to be clients later (otherwise you wouldn't have given it from your business, right?) So that is right, just keep that attitude. If you give them something from this business then that is a business gift and you can deduct $25.00 of it.

You know you are going to be visiting a relative in Florida so you send a letter out to them telling them you're coming there to talk to them about a fantastic business with super tax benefits and ask for them to send you a letter back confirming the date.

Now on foreign travel you first have to establish business intent. Now it goes the same way by sending out letters and send them out ahead of time to anyone you know there. Send out letters to our corporate headquarters asking if there is going to be any functions taking place during the time you're going to be there.

All you have to do is establish your business whether at your other beach house or ski condominium or the boat is moored there that is all you have to do. Then anytime you go up there to conduct your business all of your expenses are going to be deductiable. Your food, eating out, cleaning, the upkeep on that property, depreciation (like you got on your car), the depreciation on your furnishings, investment credit on the furnishings of that beach house or that boat or that condominium.

Now even a guest bedroom so long as any time a guest sleeps there you show them the business before they go home then that would be business purpose and you can take that room.

Telephone—What we recommend is that you get a separate telephone for your business and take all of your toll calls on that phone. If through your business you purchase a television or a microwave oven or a vacuum cleaner or clothes or any of the items we manufacture ourselves and you use that item as a sample in your business then you may be able to take either a partial or a full deduction for those items.

Now I'm going to show you another way you can save $4,000, $5,000, $6,000 in just the one area. This is the area of income transfer. There is a lot of things that children in this business can do to help you in this business and you pay them a salary. Now when you pay them a salary that is a tax deduction to you and if it is less than $3,800 the children pay no tax on it.

If you can show that you're bringing more people into your business that you are establishing more clients. If you are building your business, you can go on indefinitely taking a tax loss against other income because of the business intent.

JCX-8-82

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April 16, 1982

Honorable Fortney H. (Pete) Stark
Chairman, Subcommittee on
Select Revenue Measures
Committee on Ways and Means
Washington, DC 20515

Dear Mr. Chairman:

In announcing a public hearing (to be held April 19) on the deductibility of certain expenses incurred by self-employed individuals, the Subcommittee stated the concern that "certain individuals, particularly those engaged in certain kinds of selling activities, are being advised, and are actually attempting to convert nondeductible personal, living and family expenses into deductible business expenses***." Pursuant to your request in connection with this hearing, the staff of the Joint Committee has examined a number of Federal income tax returns filed by individuals engaged in direct-selling activities and has prepared the attached report.

The report includes examples reflecting income and deductions as shown on actual tax returns. The examples illustrate how some individuals engaged in direct-selling activities have reduced the amount of tax liability shown by them on their returns by using deductions claimed to arise from their selling activities to offset wages and other nonbusiness income. The report also includes a summary of present law on the deductibility of business and investment expenses.

In order to assure the confidentiality of taxpayer information, identification of the particular individuals who filed the returns from which the examples were prepared has been eliminated. In addition, the same general format has been used for all the examples.

Sincerely,

Mark McConaghy
Mark McConaghy

Enclosure

REPORT ON RETURNS OF INDIVIDUALS ENGAGED IN DIRECT-SELLING ACTIVITIES

The staff of the Joint Committee on Taxation has examined a number of 1979 and 1980 Federal income tax returns filed by individuals who are engaged in direct-selling activities. This report describes the returns which were examined and includes examples of income and deductions as shown on 20 such returns.

Confidentiality

Returns were provided to the Joint Committee staff by the Internal Revenue Service pursuant to section 6103(f) of the Internal Revenue Code. The required confidentiality has been assured by eliminating identification of the particular individuals who filed the returns from which the examples were prepared. In addition, the same general format has been used for all the examples. However, each example reflects income and deductions as shown on an actual tax return.

Returns studied

Neither the returns provided to the staff by the IRS nor the examples included with this report represent a valid statistical sampling of returns filed by individuals who are engaged in direct-selling activities. They do, however, illustrate actual situations in which individuals engaged in direct-selling activities have reduced the amount of tax liability shown by them on their returns by using deductions claimed to arise from their selling activities to offset wages and other nonbusiness income.

The examples included with this report are drawn from 81 tax returns selected from the work-in-progress inventories of three IRS districts. The majority of these returns came under examination through the IRS Return Preparers Program. No audit results are available with respect to the returns, because none of the individual examinations have been completed.

Profile of returns

In general, the returns furnished by the IRS reflect a married couple filing a joint return, three or four personal exemptions, gross wage and salary income in the range of $10,000 to $35,000, total business gross income (gross receipts from sales less cost of goods sold) of less than $5,000, and net business losses of up to $20,000. The categories of business deductions typically claimed on the returns include designations as automobile and transportation expenses, entertainment expenses, home meetings, lodging and meals expenses, commissions, demos and samples, awards and gifts, and home office and other office expenses. Other types of expenses claimed on one or more returns include designations as camera expenses, laundry and cleaning, suits, "outside services," household help, and "yard work."

The 20 examples drawn by the staff from the returns generally reflect this pattern.

Explanation of examples

Each example of a taxpayer return is divided into three parts: (1) summary of income and deductions as shown on the return, (2) composition of business loss claimed on the return, and (3) the tax savings resulting from claiming a net business loss on the return.

The first part of each example shows gross income (wages, total business gross income, and other income); adjusted gross income (gross income minus total business deductions); and taxable income (adjusted gross income minus itemized deductions and personal exemptions as shown on the return). The second part includes a detailed listing of categories of claimed deductions that comprise the total business deductions shown in the first part. The final part of each example shows the tax savings that resulted from offsetting the claimed net business losses against wage or other income. This tax savings computation assumes that the individual had sufficient valid business deductions to offset all gross income from the selling activity.

Because the examples are not drawn from a valid statistical sample of returns, any conclusions drawn from a review of them might not be valid generally for the total class of individuals engaged in direct-selling. However, the examples do illustrate how some individuals seek to reduce their tax liability by claiming losses from direct-selling activities to offset their wage and other nonbusiness income.

Taxpayer # 1

A. Summary of Income and Deductions as Shown on Return

Wages	$52,905
Total business gross income	3,591
Other income	789
Gross income	$57,285
Total business deductions	($14,651)
Adjusted gross income	$42,634
Itemized deductions	($6,403)
Personal exemptions	($2,000)
Taxable income	$34,231

B. Composition of Business Loss

Income:

Gross sales	$3,591	
Cost of goods sold	0	
Total gross business income		$ 3,591

Deductions

Automobile expense	$4,126	
Parking fees	80	
Road tolls	0	
Commercial transportation fees	53	
Depreciation expense (office equip.)	334	
Entertainment expense	1,103	
Convention expense	0	
Seminars	168	
Home meetings	211	
Hotel & motel expense	923	
Meals away from home	309	
Tax preparation fee	0	
Rent	112	
Printing expense	220	
Bank charges	36	
Telephone expense	702	
Postage	28	
Office supplies	783	
Freight charges	620	
Commissions paid	699	
Advertising expense	25	
Sales literature	0	
Demos & samples	1,469	
Awards & gifts	21	
Camera expense	149	
Contests	0	
Books & literature	496	
Dues & subscriptions	13	
Tapes & Recorders	1,371	
Home office	500	
Calculator	100	
Total deductions		($14,651)
Net business loss		($11,060)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$12,501
Tax shown on return	7,801
Tax savings	$ 4,700

C

Taxpayer # 2

A. Summary of Income and Deductions as Shown on Return

Wages	$23,338
Total business gross income	1,004
Other income	357
Gross income	$24,699
Total business deductions	(12,703)
Adjusted gross income	$11,996
Itemized deductions	0
Personal exemptions	(1,000)
Taxable income	$10,996

B. Composition of Business Loss

Income:

Gross sales	$1,457	
Cost of goods sold	(453)	
Total gross business income		$ 1,004

Deductions

Automobile expense	$3,221	
Parking fees	0	
Road tolls	64	
Commercial transportation fees	0	
Depreciation expense	50	
Entertainment expense	0	
Convention expense	0	
Seminars	180	
Home meetings	0	
Hotel & motel expense	324	
Meals away from home	596	
Tax preparation fee	0	
Rent	763	
Printing expense	0	
Bank charges	0	
Telephone expense	318	
Postage	10	
Office supplies	72	
Freight charges	9	
Commissions paid	0	
Advertising expense	0	
Sales literature	85	
Demos & samples	115	
Awards & gifts	0	
Camera expense	71	
Contests	0	
Books & literature	0	
Dues & subscriptions	0	
Tapes & Recorders	418	
Laundry & cleaning	75	
Business portion of new car price	5,864	
Business loss	130	
Misc.	338	
Total deductions		($12,703)
Net business loss		($11,699)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 5,093
Tax shown on return	1,597
Tax savings	$ 3,496

Taxpayer # 3

A. Summary of Income and Deductions as Shown on Return

Wages	$33,781
Total business gross income	341
Other income	596
Gross income	$34,718
Total business deductions	(8,395)
Adjusted gross income	$26,323
Itemized deductions	(6,765)
Personal exemptions	(3,000)
Taxable income	$16,558

B. Composition of Business Loss

Income:

Gross sales	$ 341	
Cost of goods sold	0	
Total gross business income		$ 341

Deductions

Automobile expense	$3,290	
Parking fees	45	
Road tolls	25	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	354	
Convention expense	0	
Seminars	1,084	
Home meetings	158	
Hotel & motel expense	100	
Meals away from home	378	
Tax preparation fee	80	
Rent	273	
Printing expense	39	
Bank charges	0	
Telephone expense	468	
Postage	30	
Office supplies	100	
Freight charges	51	
Commissions paid	0	
Advertising expense	80	
Sales literature	50	
Demos & samples	400	
Awards & gifts	196	
Camera expense	200	
Contests	0	
Books & literature	160	
Dues & subscriptions	10	
Tapes & Recorders	644	
Equipment	180	
Total deductions		(8,395)
Net business loss		($ 8,054)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 4,513
Tax shown on return	2,403
Tax savings	$ 2,110

Taxpayer #4

A. Summary of Income and Deductions as Shown on Return

Wages	$ 29,432
Total business gross income	471
Other income	428
Gross income	$ 30,331
Total business deductions	($11,434)
Adjusted gross income	$ 18,897
Itemized deductions	($ 9,082)
Personal exemptions	($ 2,000)
Taxable income	$ 7,815

B. Composition of Business Loss

Income:		
Gross sales	$ 471	
Cost of goods sold	0	
Total gross business income		$ 471
Deductions		
Automobile expense	$ 3,025	
Parking fees	212	
Road tolls	0	
Commercial transportation fees	470	
Depreciation expense	82	
Entertainment expense	76	
Convention expense	0	
Seminars	671	
Home meetings	310	
Hotel & motel expense	160	
Meals away from home	24	
Tax preparation fee	0	
Rent	0	
Printing expense	28	
Bank charges	152	
Telephone expense	919	
Postage	16	
Office supplies	545	
Freight charges	172	
Commissions paid	103	
Advertising expense	0	
Sales literature	0	
Demos & samples	1,547	
Awards & gifts	200	
Camera expense	90	
Contests	0	
Books & literature	933	
Dues & subscriptions	13	
Tapes & Recorders	880	
Storage	325	
Misc. expenses	481	
Total deductions		($11,434)
Net business loss		($10,963)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 3,487
Tax shown on return	869
Tax savings	$ 2,618

Taxpayer #5

A. Summary of Income and Deductions as Shown on Return

Wages	$20,095
Total business gross income	5,147
Other income	1,105
Gross income	$26,347
Total business deductions	($21,146)
Adjusted gross income	$ 5,201
Itemized deductions	($ 3,690)
Personal exemptions	(4,000)
Taxable income	$ 0

B. Composition of Business Loss

Income:

Gross sales	$ 5,147	
Cost of goods sold	0	
Total gross business income		$ 5,147

Deductions

Automobile expense	$ 6,586	
Parking fees	62	
Road tolls	31	
Commercial transportation fees	0	
Depreciation expense	186	
Entertainment expense	515	
Convention expense	0	
Seminars	682	
Home meetings	848	
Hotel & motel expense	381	
Meals away from home	366	
Tax preparation fee	78	
Rent	0	
Printing expense	5	
Bank charges	74	
Telephone expense	401	
Postage	38	
Office supplies	80	
Freight charges	375	
Commissions paid	4,598	
Advertising expense	82	
Sales literature	526	
Demos & samples	1,836	
Awards & gifts	425	
Camera expense	246	
Contests	0	
Books & literature	67	
Dues & subscriptions	36	
Tapes & Recorders	856	
Home office	1,766	
Total deductions		($21,146)
Net business loss		($15,999)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 1,745
Tax shown on return	0
Tax savings	$ 1,745

Taxpayer # 6

A. Summary of Income and Deductions as Shown on Return

Wages	$47,709
Total business gross income	851
Other income	1,571
Gross income	$50,131
Total business deductions	($8,125)
Adjusted gross income	$42,006
Itemized deductions	($8,854)
Personal exemptions	($3,000)
Taxable income	$30,152

B. Composition of Business Loss

Income:

Gross sales	$ 851	
Cost of goods sold	0	
Total gross business income	-	$ 851

Deductions

Automobile expense	$ 3,389	
Parking fees	50	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	164	
Convention expense	241	
Seminars	350	
Home meetings	330	
Hotel & motel expense	431	
Meals away from home	216	
Tax preparation fee	100	
Rent	0	
Printing expense	0	
Bank charges	230	
Telephone expense	365	
Postage	3	
Office supplies	241	
Freight charges	26	
Commissions paid	350	
Advertising expense	0	
Sales literature	0	
Demos & samples	390	
Awards & gifts	75	
Camera expense	32	
Contests	0	
Books & literature	85	
Dues & subscriptions	10	
Tapes & Recorders	221	
Equipment	146	
Storage	680	
Total deductions		(8,125)
Net business loss		$(7,274)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 9,119
Tax shown on return	6,303
Tax savings	$ 2,816

Taxpayer # 7

A. Summary of Income and Deductions as Shown on Return

Wages	$19,954
Total business gross income	4,325
Other income	2,285
Gross income	$26,564
Total business deductions	($17,310)
Adjusted gross income	$ 9,254
Itemized deductions	($ 5,396)
Personal exemptions	(1,000)
Taxable income	$ 2,858

B. Composition of Business Loss

Income:

Gross sales	$45,660	
Cost of goods sold	($41,335)	
Total gross business income		$ 4,325

Deductions

Automobile expense	$ 4,199	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	0	
Convention expense	0	
Seminars	0	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	0	
Telephone expense	678	
Postage	0	
Office supplies	1,648	
Freight charges	0	
Commissions paid	2,786	
Advertising expense	0	
Sales literature	0	
Demos & samples	0	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	0	
Dues & subscriptions	780	
Tapes & Recorders	0	
Utilities	249	
Misc. expenses	6,970	
Total deductions		($17,310)
Net business loss		($12,985)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 2,853
Tax shown on return	81
Tax savings	$ 2,772

Taxpayer #8

A. Summary of Income and Deductions as Shown on Return

Wages	$32,585
Total business gross income	1,004
Other income	6,653
Gross income	$40,242
Total business deductions	($10,378)
Adjusted gross income	$29,864
Itemized deductions	($2,303)
Personal exemptions	($5,000)
Taxable income	$22,561

B. Composition of Business Loss

Income:

Gross sales	$1,004	
Cost of goods sold	0	
Total gross business income		$ 1,004

Deductions

Automobile expense	$1,528	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	1,453	
Convention expense	0	
Seminars	0	
Home meetings	237	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	69	
Telephone expense	296	
Postage	7	
Office supplies	11	
Freight charges	0	
Commissions paid	262	
Advertising expense	89	
Sales literature	0	
Demos & samples	1,012	
Awards & gifts	0	
Camera expense	98	
Contests	0	
Books & literature	0	
Dues & subscriptions	70	
Tapes & Recorders	0	
Motor office expenses	3,255	
Home office	937	
Misc. expenses	1,054	
Total deductions		($10,378)
Net business loss		($ 9,374)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 6,950
Tax shown on return	3,938
Tax savings	$ 3,012

Taxpayer # 9

A. Summary of Income and Deductions as Shown on Return

Wages	$18,390
Total business gross income	1,443
Other income	490
Gross income	$20,323
Total business deductions	($13,040)
Adjusted gross income	$ 7,283
Itemized deductions	0
Personal exemptions	($ 2,000)
Taxable income	$ 5,283

B. Composition of Business Loss

Income:

Gross sales	$ 1,443	
Cost of goods sold	0	
Total gross business income		$ 1,443

Deductions

Automobile expense	$ 3,932	
Parking fees	165	
Road tolls	0	
Commercial transportation fees	300	
Depreciation expense	0	
Entertainment expense	43	
Convention expense	261	
Seminars	738	
Home meetings	1,429	
Hotel & motel expense	305	
Meals away from home	636	
Tax preparation fee	90	
Rent	0	
Printing expense	25	
Bank charges	24	
Telephone expense	672	
Postage	56	
Office supplies	103	
Freight charges	255	
Commissions paid	344	
Advertising expense	0	
Sales literature	0	
Demos & samples	1,253	
Awards & gifts	256	
C[illegible]a expense	187	
Contests	0	
Books & literature	241	
Dues & subscriptions	94	
Tapes & Recorders	651	
Home office	893	
Equipment	87	
Total deductions		($13,040)
Net business loss		($11,597)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 2,475
Tax shown on return	263
Tax savings	$ 2,212

Taxpayer #10

A. Summary of Income and Deductions as Shown on Return

Wages	$ 19,784
Total business gross income	1,919
Other income	113
Gross income	$ 21,816
Total business deductions	($ 12,351)
Adjusted gross income	$ 9,465
Itemized deductions	($ 3,923)
Personal exemptions	($ 3,000)
Taxable income	$ 2,542

B. Composition of Business Loss

Income:

Gross sales	$ 1,919	
Cost of goods sold	0	
Total gross business income		$ 1,919

Deductions

Automobile expense	$ 5,888	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense) Convention expense)	1,176	
Seminars	0	
Home meetings	73	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	1,444	
Printing expense	0	
Bank charges	148	
Telephone expense	885	
Postage	46	
Office supplies	950	
Freight charges	192	
Commissions paid	365	
Advertising expense	122	
Sales literature	437	
Demos & samples	234	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	0	
Dues & subscriptions	75	
Tapes & Recorders	0	
Insurance	60	
Laundry & cleaning	55	
Legal fees	100	
Misc. expense	101	
Total deductions		($12,351)
Net business loss		($10,432)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 1,630
Tax shown on return	0
Tax savings	$ 1,630

Taxpayer #11

A. Summary of Income and Deductions as Shown on Return

Wages	$30,441
Total business gross income	($2,810)
Other income	10
Gross income	$27,641
Total business deductions	(9,716)
Adjusted gross income	$17,925
Itemized deductions	($ 692)
Personal exemptions	($3,000)
Taxable income	$14,233

B. Composition of Business Loss

Income:

Gross sales	$2,507	
Cost of goods sold	5,317	
Total gross business income		($ 2,810)

Deductions

Automobile expense	$2,084	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense) Convention expense)	2,124	
Seminars	0	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	1,695	
Printing expense	0	
Bank charges	605	
Telephone expense	217	
Postage	50	
Office supplies	38	
Freight charges	227	
Commissions paid	0	
Advertising expense	0	
Sales literature	0	
Demos & samples	76	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	907	
Dues & subscriptions	238	
Tapes & Recorders	0	
Insurance	166	
Laundry & cleaning	66	
Taxes	347	
Utilities	364	
Suits	512	
Total deductions		($ 9,716)
Net business loss		($12,526)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 5,201
Tax shown on return	1,892
Tax savings	$ 3,309

Taxpayer #12

A. Summary of Income and Deductions as Shown on Return

Wages	$ 32,702
Total business gross income	2,129
Other income	801
Gross income	$ 35,632
Total business deductions	($16,858)
Adjusted gross income	$ 18,774
Itemized deductions	($ 7,714)
Personal exemptions	($ 4,000)
Taxable income	$ 7,060

B. Composition of Business Loss

Income:		
Gross sales	$ 2,129	
Cost of goods sold	0	
Total gross business income		$ 2,129
Deductions		
Automobile expense	$ 6,010	
Parking fees	69	
Road tolls	36	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	0	
Convention expense	415	
Seminars	1,275	
Home meetings	403	
Hotel & motel expense	1,599	
Meals away from home	685	
Tax preparation fee	108	
Rent	0	
Printing expense	106	
Bank charges	19	
Telephone expense	882	
Postage	32	
Office supplies	136	
Freight charges	175	
Commissions paid	1,116	
Advertising expense	0	
Sales literature	0	
Demos & samples	487	
Awards & gifts	15	
Camera expense	596	
Contests	0	
Books & literature	98	
Dues & subscriptions	126	
Tapes & Recorders	1,773	
Storage	500	
Misc. expense	197	
Total deductions		($16,858)
Net business loss		($ 14,729)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 3,714
Tax shown on return	546
Tax savings	$ 3,168

Taxpayer # 13

A. Summary of Income and Deductions as Shown on Return

Wages	$ 37,498
Total business gross income	2,711
Other income	711
Gross income	$ 40,920
Total business deductions	($14,341)
Adjusted gross income	$ 26,579
Itemized deductions	($ 2,417)
Personal exemptions	($ 4,000)
Taxable income	$ 20,162

B. Composition of Business Loss

Income:

Gross sales	$ 2,711	
Cost of goods sold	0	
Total gross business income		$ 2,711

Deductions

Automobile expense	$ 4,664	
Parking fees	36	
Road tolls	146	
Commercial transportation fees	273	
Depreciation expense	0	
Entertainment expense	567	
Convention expense	273	
Seminars	914	
Home meetings	508	
Hotel & motel expense	303	
Meals away from home	641	
Tax preparation fee	0	
Rent	0	
Printing expense	26	
Bank charges	8	
Telephone expense	683	
Postage	72	
Office supplies	32	
Freight charges	285	
Commissions paid	1,738	
Advertising expense	0	
Sales literature	0	
Demos & samples	1,348	
Awards & gifts	326	
Camera expense	58	
Contests	0	
Books & literature	42	
Dues & subscriptions	34	
Tapes & Recorders	228	
Legal fees	110	
Home office	1,026	
Total deductions		($14,341)
Net business loss		($11,630)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 6,895
Tax shown on return	3,267
Tax savings	$ 3,628

Taxpayer # 14

A. Summary of Income and Deductions as Shown on Return

Wages	$ 0
Total business gross income	2,797
Other income	33,491
Gross income	$ 36,288
Total business deductions	($25,292)
Adjusted gross income	$10,996
Itemized deductions	($ 4,908)
Personal exemptions	($ 4,000)
Taxable income	$ 2,088

B. Composition of Business Loss

Income:

Gross sales	$ 2,797	
Cost of goods sold	0	
Total gross business income		$ 2,797

Deductions

Automobile expense	$ 4,005	
Parking fees	5	
Road tolls	27	
Commercial transportation fees	414	
Depreciation expense (office furn.)	415	
Entertainment expense	1,056	
Convention expense	1,733	
Seminars	84	
Home meetings	820	
Hotel & motel expense	115	
Meals away from home	126	
Tax preparation fee	155	
Rent	0	
Printing expense	149	
Bank charges	124	
Telephone expense	432	
Postage	255	
Office supplies	817	
Freight charges	1,004	
Commissions paid	406	
Advertising expense	0	
Sales literature	606	
Demos & samples	7,559	
Awards & gifts	1,848	
Camera expense	86	
Contests	347	
Books & literature	0	
Dues & subscriptions	118	
Tapes & Recorders	31	
Home office	1,160	
Interpreting expense	296	
Outside services	1,099	
Total deductions		($25,292)
Net business loss		($22,495)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 4,498
Tax shown on return	0
Tax savings	$ 4,498

Taxpayer # 15

A. Summary of Income and Deductions as Shown on Return

Wages	$33,234
Total business gross income	718
Other income	0
Gross income	$33,952
Total business deductions	($ 8,308)
Adjusted gross income	$25,644
Itemized deductions	($ 4,591)
Personal exemptions	(2,000)
Taxable income	$19,053

B. Composition of Business Loss

Income:

Gross sales	$ 718	
Cost of goods sold	0	
Total gross business income		$ 718

Deductions

Automobile expense	$ 3,936	
Parking fees	46	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	74	
Convention expense	689	
Seminars	259	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	125	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	0	
Telephone expense	181	
Postage	22	
Office supplies	0	
Freight charges	270	
Commissions paid	23	
Advertising expense	79	
Sales literature	858	
Demos & samples	630	
Awards & gifts	225	
Camera expense	62	
Contests	0	
Books & literature	158	
Dues & subscriptions	7	
Tapes & Recorders	236	
Storage	428	
Total deductions		($ 8,308)
Net business loss		($ 7,590)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 5,153
Tax shown on return	3,003
Tax savings	$ 2,150

Taxpayer # 16

A. Summary of Income and Deductions as Shown on Return

Wages	$11,416
Total business gross income	718
Other income	929
Gross income	$13,063
Total business deductions	($11,391)
Adjusted gross income	$ 1,672
Itemized deductions	($ 2,506)
Personal exemptions	($ 1,000)
Taxable income	$ 0

B. Composition of Business Loss

Income:

Gross sales	$ 718	
Cost of goods sold	0	
Total gross business income		$ 718

Deductions

Automobile expense	$ 6,769	
Parking fees	10	
Road tolls	15	
Commercial transportation fees	606	
Depreciation expense	0	
Entertainment expense	0	
Convention expense	117	
Seminars	155	
Home meetings	702	
Hotel & motel expense	782	
Meals away from home	142	
Tax preparation fee	89	
Rent	0	
Printing expense	0	
Bank charges	18	
Telephone expense	175	
Postage	12	
Office supplies	281	
Freight charges	40	
Commissions paid	230	
Advertising expense	0	
Sales literature	0	
Demos & samples	340	
Awards & gifts	10	
Camera expense	32	
Contests	0	
Books & literature	232	
Dues & subscriptions	10	
Tapes & Recorders	0	
	624	
Total deductions		($11,391)
Net business loss		($10,673)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 1,140
Tax shown on return	0
Tax savings	$ 1,140

Taxpayer #17

A. Summary of Income and Deductions as Shown on Return

Wages	$ 30,160
Total business gross income	1,407
Other income	0
Gross income	$ 31,567
Total business deductions	($14,110)
Adjusted gross income	$ 17,457
Itemized deductions	($ 6,603)
Personal exemptions	($ 3,000)
Taxable income	$ 7,854

B. Composition of Business Loss

Income:

Gross sales	$ 1,407	
Cost of goods sold	0	
Total gross business income		$ 1,407

Deductions

Automobile expense	$ 5,472	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	24	
Depreciation expense	293	
Entertainment expense	0	
Convention expense	692	
Seminars	461	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	30	
Rent	0	
Printing expense	0	
Bank charges	260	
Telephone expense	301	
Postage	85	
Office supplies	915	
Freight charges	0	
Commissions paid	0	
Advertising expense	0	
Sales literature	0	
Demos & samples	1,218	
Awards & gifts	43	
Camera expense	0	
Contests	79	
Books & literature	126	
Dues & subscriptions	97	
Tapes & Recorders	0	
Security system	425	
Insurance	83	
Household help	272	
Yard work	36	
Business debt interest	1,354	
Repairs	66	
Taxes	371	
Utilities	808	
Furniture	689	
Total deductions		($14,110)
Net business loss		($12,703)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 3,378
Tax shown on return	680
Tax savings	$ 2,698

Taxpayer # 18

A. Summary of Income and Deductions as Shown on Return

Wages	$ 33,177
Total business gross income	10,670
Other income	1,595
Gross income	$ 45,442
Total business deductions	($30,576)
Adjusted gross income	$ 14,866
Itemized deductions	($ 7,714)
Personal exemptions	(3,000)
Taxable income	$ 4,152

B. Composition of Business Loss

Income:

Gross sales	$ 10,670	
Cost of goods sold	0	
Total gross business income		$ 10,670

Deductions

Automobile expense	$ 6,665	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	4,876	
Convention expense	0	
Seminars	0	
Home meetings	364	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	42	
Rent	1,129	
Printing expense	0	
Bank charges	192	
Telephone expense	438	
Postage	122	
Office supplies	662	
Freight charges	404	
Commissions paid	2,954	
Advertising expense	1,075	
Sales literature	0	
Demos & samples	2,888	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	0	
Dues & subscriptions	155	
Tapes & Recorders	0	
Sales & promotion	5,159	
Misc. supplies	331	
Interest	2,498	
Insurance	522	
Legal services	100	
Total deductions		($30,576)
Net business loss		($19,906)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 4,358
Tax shown on return	186
Tax savings	$ 4,172

Taxpayer # 19

A. Summary of Income and Deductions as Shown on Return

Wages	$ 18,208
Total business gross income	2,053
Other income	0
Gross income	$ 20,261
Total business deductions	($15,023)
Adjusted gross income	$ 5,238
Itemized deductions	($ 1,267)
Personal exemptions	($ 4,000)
Taxable income	$ 0

B. Composition of Business Loss

Income:

Gross sales	$ 2,053	
Cost of goods sold	0	
Total gross business income		$ 2,053

Deductions

Automobile expense	$ 8,636	
Parking fees	100	
Road tolls	106	
Commercial transportation fees	356	
Depreciation expense	0	
Entertainment expense	58	
Convention expense	0	
Seminars	126	
Home meetings	104	
Hotel & motel expense	723	
Meals away from home	75	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	52	
Telephone expense	1,456	
Postage	0	
Office supplies	218	
Freight charges	120	
Commissions paid	446	
Advertising expense	17	
Sales literature	49	
Demos & samples	454	
Awards & gifts	32	
Camera expense	72	
Contests	16	
Books & literature	0	
Dues & subscriptions	7	
Tapes & Recorders	488	
Home office	816	
Misc. expense	496	
Total deductions		($15,023)
Net business loss		($12,970)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 1,619
Tax shown on return	0
Tax savings	$ 1,619

Taxpayer #20

A. Summary of Income and Deductions as Shown on Return

Wages	$15,900
Total business gross income	1,155
Other income	0
Gross income	$17,055
Total business deductions	(9,521)
Adjusted gross income	$ 7,534
Itemized deductions	0
Personal exemptions	(2,000)
Taxable income	$ 5,534

B. Composition of Business Loss

Income:		
Gross sales	$ 1,155	
Cost of goods sold	0	
Total gross business income		$ 1,155
Deductions		
Automobile expense	$ 3,489	
Parking fees	36	
Road tolls	96	
Commercial transportation fees	17	
Depreciation expense	0	
Entertainment expense	343	
Convention expense	0	
Seminars	468	
Home meetings	760	
Hotel & motel expense	293	
Meals away from home	262	
Tax preparation fee	15	
Rent	500	
Printing expense	0	
Bank charges	273	
Telephone expense	1,008	
Postage	24	
Office supplies	209	
Freight charges	79	
Commissions paid	0	
Advertising expense	67	
Sales literature	119	
Demos & samples	219	
Awards & gifts	367	
Camera expense	71	
Contests	63	
Books & literature	197	
Dues & subscriptions	153	
Tapes & Recorders	393	
Total deductions		(9,521)
Net business loss		($ 8,366)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	$ 2,206
Tax shown on return	474
Tax savings	$ 1,732

PRESENT LAW ON DEDUCTIBILITY
OF
BUSINESS AND INVESTMENT EXPENSES

Overview

Subject to certain limitations and substantiation requirements, expenses incurred by an individual in carrying on a trade or business are deductible for income tax purposes (Code sec. 162), as are expenses incurred in an investment activity (sec. 212). If the expenses from a business or investment activity exceed the taxpayer's income from the business or investment activity for the year, the net business loss may be used to offset income from other sources, such as employee wages paid to the taxpayer.

Under present law, an activity in which the taxpayer incurs expenditures is presumed to be engaged in for profit (and hence is not subject to the "hobby loss" deduction limitations) if the activity produces net income for at least two years in a period of five consecutive years (sec. 183). Accordingly, as long as an activity shows a profit for any two years within the five-year period, the taxpayer generally may offset income from other sources with excess deductions from the activity in the loss years, unless the Internal Revenue Service can overcome the presumption by establishing that the taxpayer in fact did not engage in the activity for profit.

Except for certain expenses allowed as "above-the-line" deductions or as itemized deductions, an individual's personal or consumption expenditures are not deductible (see sec. 262, disallowing deductions for personal, living, or family expenses). Certain expenditures which otherwise would be treated as personal living expenses, such as expenditures for meals, lodging, travel, or entertainment, nonetheless may be deductible when incurred in a business or investment activity.

Expenses incurred in a trade or business

General rules

An individual may deduct all the ordinary and necessary expenses paid or incurred in carrying on a trade or business (sec. 162).

The determination of whether an activity in which expenditures are incurred constitutes a trade or business depends on the particular facts involved. In general, to constitute a trade or business there must be activities which are carried on for livelihood or profit and which occur on a regular basis. An employee is considered to be in the trade or business of being an employee, and may deduct certain expenses incurred as an employee.[1/]

An individual may be engaged in more than one trade or business at a time. Thus, an individual who is an employee may incur deductible expenses from self-employment or investment activities. If the expenses from a business or investment activity exceed the taxpayer's income from that business or investment activity for the year, the net business or investment loss may be used to offset income from other sources, such as employee wages paid to the taxpayer or net income from another trade or business of the taxpayer.

To be deductible, expenses incurred in a trade or business must not be "capital expenditures" and must be "ordinary and necessary" to the operation of the business. In general, a capital expenditure is a cost, other than routine maintenance, incurred for assets or improvements to be used for an extended period. (Such expenditures for business assets, normally may be recovered through depreciation allowances.) As with the definition of trade or business, the determination of whether an expense is ordinary and necessary to the operation of the business is a factual question. The Supreme Court has ruled that expenses do not have to be "habitual or normal in the sense that the same taxpayer will have to make them often" to be ordinary.

Types of deductible expenses

Section 162 specifically lists three categories of trade or business expenditures which are deductible. However, this listing is not exclusive, and other types of trade or business expenses may qualify for deduction pursuant to section 162.

The first listed category of section 162 expenses consists of reasonable allowances for salaries and other compensation for personal services. The principal issue which arises concerning

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[1/] The employee business expenses which are deductible in determining adjusted gross income ("above-the-line deductions") are limited to the following expenses if paid or incurred by the taxpayer in connection with the performance of services as an employee: (1) expenses of travel, meals, and lodging while away from home; (2) other expenses covered by a reimbursement or other expense allowance arrangement with the employer; (3) transportation costs; and (4) expenses of "outside salesmen" (sec. 62(2)). In addition, an individual who itemizes deductions may deduct other employee business expenses (such as union dues or continuing professional education costs).

deductions claimed for compensation is whether the total of amounts paid is reasonable in light of the services performed. For example, a corporation may not deduct as compensation amounts paid to a shareholder-employee that are in substance dividends because they exceed reasonable compensation levels. Similarly, an individual operating a business as a sole proprietorship may also violate the reasonableness standard if the individual pays compensation to family members in excess of the value of services in an effort to "income-split" and thereby to maximize the amount of total family income taxable in lower brackets.

The second listed category consists of traveling expenses incurred while away from home in pursuit of business. Expenses of commuting to the taxpayer's place of business are nondeductible personal expenses. However, a taxpayer having more than one place of business may deduct the costs of traveling from one place of business to another. In addition, where the taxpayer is away from home in the pursuit of a trade or business, 2/ the taxpayer may deduct traveling expenses, 3/ including the costs of meals and lodging (other than amounts which are lavish or extravagant under the circumstances).

The third listed category of section 162 expenses consists of rentals paid for business property. A deduction may only be claimed for rent which does not exceed the fair market value of

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2/ The travel must be primarily for business purposes. Thus, if a taxpayer makes a business trip (such as attending a convention) and engages in some personal activity such as sightseeing, that part of the total expenses of the trip which is directly attributable to the taxpayer's business is deductible, while expenses attributable to personal activities are nondeductible (Rev. Rul. 79-425, 1979-2 C.B. 81, and Rev. Rul. 56-168, 1956-1 C.B. 93).

3/ If an individual uses an automobile for business purposes (other than for commuting between home and the place of business), he or she may deduct expenses based on a standard mileage rate or based on actual costs incurred. The standard mileage rate is presently 20 cents a mile for the first 15,000 miles, and 11 cents a mile for each additional mile (or for all miles after the car is considered to be fully depreciated, i.e., after 60,000 miles of business use at the maximum rate). The standard rate includes all operating expenses and depreciation allowances.

Alternatively, the taxpayer may elect to deduct automobile expenses based on actual costs incurred and to claim an investment tax credit on the cost of a newly acquired automobile. Deductible expenses under the actual expense method include the cost of gasoline, oil, repairs, insurance, depreciation, licenses, and garage rent.

Parking fees and tolls are deductible separately under both the standard mileage and actual expense methods.

premises actually used for business purposes. In the case of business property purchased by the taxpayer, the cost [illegible] the property may be recovered through depreciation deductions.

Expenses incurred for the production of income

A taxpayer may deduct all the ordinary and necessary expenses paid or incurred for production or collection of income; for managing, conserving, or maintaining property held for the production of taxable income; or in connection with the determination of any tax (sec. 212). 4/ These expenses are deductible even though the income-producing activity does not constitute a trade or business under section 162.

Like business expenses, section 212 expenses are deductible only if they are not capital expenditures and are ordinary and necessary expenses to production of the income involved. Thus, the same types of expenses that may be deducted as costs of doing business generally may be deducted when incurred in an investment activity.

Substantiation requirements

Business or investment expenses are generally deductible only if the taxpayer substantiates that he or she actually incurred the expense. If the taxpayer establishes that a deductible expenditure has been incurred, but fails to substantiate the exact amount, the deduction generally may be allowed based on an approximated amount (Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930)). However, section 274 requires substantiation of the amount of the expenditure in the case of traveling expenses, entertainment costs, or business gifts (see discussion below).

Limitations on deductible expenses

Present law provides three major limitations on the availability of deductions [illegible] expenses claimed to be incurred in business and income-producing activities.

Hobby losses

Hobbies and other activities may resemble business activities although they are not intended to produce a profit. To preclude the claiming of tax losses from such activites to shelter other income, present law restricts deductions in respect of "activities not engaged in for profit" (sec. 183). Under this rule, if an activity is not engaged in for profit, allowable deductions are limited to those amounts which could be deducted without regard

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4/ Expenses incurred for production of tax-exempt income are not deductible (sec. 265).

to the nature of the activity in which incurred (such as certain interest or taxes), plus other expenses in an amount not exceeding the income produced by the activity.

Present law presumes an activity to be engaged in for profit if the activity produces net income for any two or more taxable years in a period of five consecutive taxable years. 5/ Accordingly, so long as an activity shows a profit for any two years within the five-year period, the taxpayer generally may offset income from other sources with excess deductions from the activity in the loss years, unless the Internal Revenue Service can overcome the presumption by establishing that the taxpayer in fact did not engage in the activity for profit. If a particular activity fails to meet the two-of-five-years test, net losses from the activity generally still may be used to offset other income unless the activity is considered not to be engaged in for profit. However, in that case the taxpayer does not get the benefit of the presumption.

If the taxpayer elects, the two-of-five-years determination will not be made before the end of the fourth taxable year, 6/ and the activity will be treated as a business or investment activity until the determination is made. During the period before this determination is made, all deductions otherwise allowable for business or investment expenses can be claimed, subject to later disallowance. Thus, while present law limits deductions when an activity does not have a true profit-making business or investment motive, it permits the taxpayer to defer for up to several years payment of tax on income from other sources to the extent of losses claimed from the activity.

Travel and entertainment expenses

Under section 274, no deduction generally is permitted for expenditures attributable to entertainment unless the entertainment is "directly related to" the active conduct of the taxpayer's business or investment activity; 7/ this requirement is in addition

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5/ In the case of breeding and training race horses, the presumption test is two years of seven consecutive years.

6/ The sixth taxable year in the case of breeding and training race horses.

7/ Entertainment expenses incurred directly before or after a "substantial and bona fide" business discussion are deductible as "associated with" the business even though they are not "directly related to" its conduct. Costs of facilities (e.g., hunting lodges) are considered entertainment expenses.

to the rule limiting all deductible business or investment expenses to those that are ordinary and necessary. In general, entertainment expenses meet the "directly related" test only if (1) the taxpayer expects to derive income or some other specific business benefit (other than goodwill) from the activity; (2) the taxpayer engages in the active conduct of business during the entertainment with the person being entertained; and (3) the active conduct of business is the principal aspect of the combined business and entertainment (Reg. §1.274-2(c)(3)).

Section 274 provides special substantiation requirements for travel and entertainment expenses that are more stringent than the requirements for other types of business and investment expenses. No deduction is allowed for any traveling expense (including meals and lodging while away from home), any entertainment expense, or any business gift expense unless the taxpayer maintains records corroborating the item. 8/ These records must show (1) the amount of each such expense or other item; (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift.

Business use of home

The tax law imposes limitations on deductions for business use of the taxpayer's home (sec. 280A). A taxpayer may deduct expenses attributable to use of the home for business purposes only for that portion of the home that is used exclusively and on a regular basis as the principal place of business of a trade or business of the taxpayer, or as a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's business. Section 280A also contains special rules restricting deduction of expenses incurred in connection with "vacation homes."

Personal, living, and family expenses

In general, personal, living, or family expenses are not deductible in determining taxable income (sec. 262). Examples of such nondeductible expenses are the costs of maintaining a personal residence (e.g., rent, utilities, or depreciation), expenses incurred while traveling away from home (e.g., meals and lodging) to the extent the travel is not primarily for business purposes, expenses of commuting from home to the taxpayer's place of business, and costs incurred for education which does not either maintain or improve skills required in the taxpayer's business or satisfy requirements imposed by the taxpayer's employer.

Present law includes several exceptions to the general rule denying deductions for personal expenses. These exceptions include certain "above-the-line" deductions (e.g., alimony and the deduction for two-earner married couples) and certain itemized deductions (e.g., interest, taxes, casualty losses, charitable contributions, and medical expenses).

8/ Sec. 274 also contains special rules governing expenses of foreign travel and business gifts.

Congressman **Stark**. Thank you.

I am really appearing here not to go back over all of the revenue raising issues that we have hashed and rehashed and have been so thoroughly studied by the staffs on both sides of the Hill, by the Joint Committee staff and by the Treasury, but to raise the issue that we held hearings on April 19. And that is the problem of certain self-employed individuals taking deductions in an attempt to convert personal expenses into deductible business expenses.

The question of fault is not very relevant. We were surprised to learn that the Treasury and the IRS had this same problem under investigation unbeknownst to us. If you want to point to an area where we perhaps need stricter regulations, it would be certain tax preparers who I would classify as unscrupulous at best and perhaps dishonest, if not illegal in getting people to hire their children as employees, even though they may be 3 years old. In other words, turning Sonny into a sales aide or their pet family dog Scotty into a security officer by virtue of the fact that some modest amount of inventory is stored in the home. These are clearly illegal deductions, yet they are being advocated by some in the independent contractor sector.

What I would like to suggest is that this is becoming the cocktail party conversation gambit that has now replaced the fact that you used to be able to make a lot of profit in condominiums.

I think what my mail is showing me since our hearings is that, boy, you ain't heard nothing yet, Congressman. You should hear what my brother-in-law in Ipsolanti is doing or you should hear what my cousin in Oakland is doing. People are beginning to feel like suckers if they obey the law. And I think that we, in Congress, ought to give a clear message to people who may be tempted to exceed what is reasonable and necessary in the way of business deductions, and put an end to it as quickly as we can.

On the assumption that the Treasury and the Joint Committee will help us to find either some regulations which we could encourage or legislation, if it is necessary, this seems to me to be the ideal time to discuss such proposals, and to perhaps tighten the regulations on the deduction side as well as the compliance side in reporting all the income earned.

That is, in general, the nature of my request to this distinguished Committee, and I would be glad to answer any questions or discuss it further, as you wish.

Senator **Grassley**. Senator Dole.

Senator **Dole**. I appreciate the information. I just started looking through some of the samples furnished by Mark McConaghy of the Joint Committee on Taxation, and we will review this material carefully. Did the hearing held in your subcommittee last week uncover data which may be generally representative of the industry? Do you think it is fairly widespread?

Congressman **Stark**. I think it is widespread geographically. I think it knows no particular member of the industry or no particular class. It has been traced through certain preparers. I don't even want to mention an industry for fear of suggesting something. Let's say they find home milk deliverers who use horsedrawn wagons in a certain part of this country, and one preparer may draw a tax return for that person, and through the union of horsedrawn milk deliverers to the home that same preparer prepares 50 or 60 returns, and a pattern evolves of spurious deductions, say, for a truck when they are using a horse to deliver the milk, and the IRS has found it happening in certain areas of the country, but certainly not restricted to any one company, any one part of the Nation, or any one industry.

Senator DOLE. What about overstating deductions? Is that greater with direct sellers than any other industry? Have you had a chance to focus on that?

Congressman STARK. My inclination is that it is greater among self-employed. Now this may not necessarily be direct sellers. It might just as well be the trade person who has a truck and provides service to homeowners, but those people who prepare that person's tax return are perhaps the area of greatest concern. I think there are people who never intended in good faith to enter into the direct selling profession. It was just a low capital entry level way for them to say I have another business, and to offset otherwise earned income on which they would have owed taxes.

Senator DOLE. I have no other questions. I appreciate receiving the information in your statement. We do hope that these hearings are called rather quickly and that we might be able to incorporate this bill in with the other provisions in the tax compliance effort because, as you know, a lot of people don't pay any taxes at all, and the rest of the people have to pay more. It is estimated that it's $95 billion in revenue we are losing this year. We think at least this would be a step in the right direction—maybe not as good as we probably should do.

Congressman STARK. Senator, you are right, and the public hearing about people who are getting away with it is what makes the honest law-abiding taxpayer mad, and I think we have to do something about it to preserve our system.

Senator GRASSLEY. Well, Congressman, I don't have any questions. I want to thank you for coming this morning, and I look forward to continued dialog with you as this bill moves through the legislative process.

Congressman STARK. Thank you for the opportunity to appear.

Senator GRASSLEY. It's my pleasure now to call the Honorable John E. Chapoton, assistant secretary for tax policy, Department of the Treasury, Washington, D.C. And I think the members of the Finance Committee owe you a compliment, Secretary Chapoton, for the many times you have had to appear before our committees. You are always well informed on all these issues that come before us. You seem to always be a person who is up on the information we need. We want to thank you for that.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Secretary CHAPOTON. Thank you, Mr. Chairman. That can be attributed primarily to a very able staff, as you and Chairman Dole know.

I am pleased to be here today to present the Treasury Department's views on S. 2369. I am accompanied by Percy Woodard, the assistant commissioner, examination, of the Internal Revenue Service.

Because the moratorium on the reclassification and issuance of regulations and rulings regarding the status of individuals for employment tax purposes expires on June 30 of this year, I agree with the Chairman and with Senator Dole and his cosponsors that renewed consideration of this issue is imperative. The moratorium has only delayed a solution to the problem. Both taxpayers and tax administrators will benefit from its solution.

In dealing with the employee-independent contractor issue, our principal concern should be the low compliance that independent contractors as a group have shown with respect to both income taxes and social security taxes. Noncompliance in our tax laws is a serious and growing problem. In this time of unprecedented fiscal austerity, we must take all available measures to prevent taxpayers from underreporting their income or overstating deductions or exemptions claimed on filed returns.

In 1979, the Internal Revenue Service undertook a study of the income tax and social security tax compliance of independent contractors. This study has drawn a lot of criticism and discussion, Mr. Chairman. But even if some of the criticism were justified, the results of the study show such significant noncompliance that its basic conclusion cannot be overlooked.

The 1979 study showed substantial underreporting for income tax purposes, and even greater underreporting for social security purposes among the workers studied. Approximately 22 percent of the income that should have been reported—that is $1 out of each $5—was not reported. And 15 percent of the income tax liabilities on the amount covered in the study was not paid. Almost 45 percent of the workers in the study reported absolutely none of the income they earned as to which there was no withholding.

These figures indicate nonreporting was greater among workers with smaller amounts of payments.

With respect to social security taxes, the underreporting was even greater than it was with respect to income taxes.

We cannot afford this high rate of noncompliance among independent contractors. Compliance measures do not impose new taxes, they merely insure collection of taxes otherwise due. So the question before us and before this subcommittee is how do we improve compliance among independent contractors.

Although the question is a compliance problem, the controversy in the independent contractor area has focused on another question, that is, the definition of an independent contractor. And although the compliance question and the definition question are linked, they are not identical. If we correctly define the term "independent contractor," we are still faced with the question of achieving the best compliance within that group.

Under the Internal Revenue Code, compensation is subject to withholding of income and employment taxes only if an employer/employee relationship exists under common law. Also, social security or FICA taxes and Federal unemployment taxes are due only if that relationship exists. An employee is subject to withholding at graduated rates for income tax purposes, while a self-employed individual makes quarterly estimated tax payments. And the payor does not withhold. It is this disparity in collection which has put much pressure on the definition of independent contractors.

A worker is considered an employee under the common law when the person for whom the services are performed has the right to control and direct the individual. Under common law, some 20 factors are applied in determining whether this status exists. Thus, determinations of employment status are heavily dependent upon the specific facts of each individual case.

Although the independent contractor dispute has been cast in terms of whether the payor has the right to exercise control of the worker, that historical development does not necessarily prove determinative of whether withholding at graduated rates is appropriate for a particular worker. If a worker's gross remuneration approximates his net income, withholding at graduated rates would accurately collect the correct amount of tax. Indeed, from the standpoint of the worker, withholding is the most convenient and the least disruptive method of satisfying his tax obligation. On the other hand, if a worker's net income departs substantially from his gross income, the current system of withholding would produce overwithholding and would probably not be an accurate or desirable tax collection method. An attempt in that instance to make it more accurate would present significant administrative problems.

If a safe harbor definition of independent contractor will exempt a worker from the withholding system applicable to employees, the elements of that safe harbor should attempt to isolate and cover cases in which withholding or gross remuneration would not be sensible. Items such as substantial investment or unreimbursed expenses are key, while conditions of employment and control over those conditions, even though they often indicate independence, may not be determinative or even germane, except to show the administrative feasibility of withholding.

A balanced approach to classification, therefore, should provide an appropriate but narrow safe harbor while retaining the common law to deal with taxpayers who do not meet the specific statutory provisions.

In our view, however, the safe harbor of S. 2369 could include virtually all cases in dispute at the enactment of the moratorium. This could exacerbate the serious compliance problem that exists under current law.

S. 2369 would add a statutory safe harbor to the Code. Since the provision is elective, it would apply only where the service recipients supply a written contract and notice of tax responsibilities to the worker prior to the service being performed, and only if the service recipient complies with information reporting requirements.

To qualify under the safe harbor provided in S. 2369 an individual must meet all three of the following additional requirements: (1) The control of hours worked test; (2) the place of business test; and (3) investment or income fluctuation test. Let me go into those three tests in a bit of detail, Mr. Chairman.

As the tests making up a safe harbor should be designed to indicate whether withholding on a worker's gross remuneration is accurate, in our view control of a worker's hours is seldom relevant to this determination. Nevertheless, we recognize that it is an important factor under common law. And, thus, it is not inappropriate to include a control of hours worked test in a safe harbor.

But with the qualifications contained in the control of hours worked test in S. 2369, we are concerned that the test could be easily met in most instances. The line between control of hours and control of access to premises on work sites can be a fine one. Therefore, if a control of hours test is to be included in the safe harbor, we would request that it be more tightly drawn.

We agree that an investigation of a taxpayer's investment in his business can be a surrogate for determining whether his gross remuneration approximates his net income. We thus agree that a place of business test is appropriate, provided that the test is met only if there is a place of business which represents a substantial investment. If the place of business is in the taxpayer's home, we think the section 280A requirements of the Code should be met, that is, exclusive use on a regular basis of that place in the home.

Furthermore, the place of business should be separate from that of the service recipient. In our view, allowing an individual to satisfy the safe harbor even though the place of work is provided by the service recipient could easily be subject to manipulation.

The third test of the safe harbor rules in S. 2369 is one designed to determine whether a worker is economically independent because he has substantial investment in assets, or because he risks income fluctuation. We believe that the investment in assets test in the bill provides sufficient flexibility to cover instances in which individuals have substantial capital invested in their businesses. It is important, however, that situations in which the property either is leased from or financed by the service recipient be carefully circumscribed, so that only a good faith arm's length arrangement could meet the test.

Turning to the income fluctuation test in the bill, it should be made clear that if remuneration is provided in the form of guaranteed amounts, reimbursed expenses or other benefits, this test could not be met. The test is meaningless if it does not insure that the worker bear some risk of loss. We think that a more meaningful test would be the amount of an individual's unreimbursed expenses of a particular type, such as payroll expenses, supplies or cost of goods sold, in relation to his income. Where a worker has substantial unreimbursed expenses which could cause withholding to overstate his periodic tax payments, safe harbor treatment would clearly be justified.

To summarize our position Mr. Chairman, we support the retention of common law and a safe harbor, as S. 2369 would do. But the safe harbor test, we feel, must be tailored to include only those taxpayers for whom withholding under the current system would be most inappropriate.

We think a preferable safe harbor would be one covering only cases in which an individual is paid on other than an hourly or salaried basis, and meets one of the following conditions: The worker maintains a principal place of business including a part of the home qualifying under section 280A, or has substantial assets used in connection with the performance of the services, or incurs substantial unreimbursed expenses of a particular type, such as payroll expenses, supplies, or the cost of goods sold, in performing the services.

We would also adopt the requirements of S. 2369 with respect to written contracts, notice, and compliance with information reporting.

Further, we would require an antiswitching rule, which would prevent employers who have treated their workers as employees under current law from switching these workers to independent contractor status merely because of insubstantial changes in the employment relationship which could satisfy the safe harbor. S. 2369 recognized this problem by providing a transitional anti-switching rule, but we think this should be made permanent.

The remainder of S. 2369 deals with the question of how to raise the compliance of those workers who are classified as independent contractors, and, thus, who are exempt from withholding under current law. I will confine my remarks to the provisions and to the approach followed in the bill.

Information reporting on transactions is valuable to both the Government, to enable it to check the information reported by taxpayers through matching and other means, and to the vast majority of taxpayers who conscientiously attempt to report all of their income. Under current law, the threshold for information reporting is $600 a year, which is largely unchanged by S. 2369. We think it would be appropriate to consider substantially lowering this figure with respect to payments for services. Indeed, in the area of interest and dividends, the reporting threshold is currently $10. And wages, of course, are subject to reporting and withholding from the first dollar earned. Compliance would improve if taxpayers knew that their payments for services had been reported to the Internal Revenue Service.

We welcome the recognition in S. 2369 that information reporting by direct sellers should be expanded. Initially, our view was that information reporting on a specific dollar amount of gross sales would be of use to the Internal Revenue Service both in identifying individuals in this industry with self-employment income, and in verifying the gross receipts reportable on schedule C.

However, the Service has been considering what information from the direct selling industry it could best use to determine accurate tax liabilities in this area. After close examination, and taking into account the difficulties in comparing gross sales with amounts reported by taxpayers on their returns, the Service now has concluded that they will be better able to utilize mandatory information reporting on commissions, bonuses, prizes, and the like, in excess of $100 in a calendar year.

At the same time, the Service must have some means to obtain information on those sellers who are compensated only by the difference in the price at which they purchase goods and then resell them for use in the home. We therefore support reporting of the name, address, and taxpayer identification number for gross purchases in excess of $100 annually.

We do not think that an exception to the normal unlimited statute of limitations for failure to file a return should be made for information returns required to be filed with respect to independent contractors, as S. 2369 would do. Recordkeeping requirements exists for all taxpayers. Therefore, we would suggest that this provision be dropped from the bill.

With respect to the penalties contained in the bill, we believe that a percentage penalty for failure to file or to furnish information returns relating to independent contractors is appropriate. The step increases in the penalty rate based upon the reporting agent's overall compliance as provided in this bill is somewhat complex. We are concerned that this might prove difficult to administer. We appreciate that its purpose is to provide a stiffer penalty on large payors for noncompliance, which we support, but we think a penalty computed as a percentage of compensation not reported is probably adequate.

Finally, imposing withholding where there is a missing or incorrect taxpayer identification number is an appropriate and desirable sanction. By implementing source withholding on persons not willing to provide correct numbers, this provision will place the onus of correct information reporting on the person best able to insure that the reporting is accurate.

Mr. Chairman, I would like to make several comments about the social security taxes imposed on independent contractors. I think it's fully understood that self-employment contribution act payments, SECA payments, paid by self-employed persons are lower than taxes an employee must bear under FICA. Even though one-half of the FICA tax is borne by the employer, I think it is generally recognized that this burden is, in fact, ultimately borne by the employee in the form of lower wages. But based on similar earnings histories, independent contractors and other self-employed persons receive the same social security benefits as employees, even though they obviously contribute significantly less to the trust funds. It would be possible to reduce the tax advantages inherent in independent contractor status by more closely conforming the FICA and SECA tax rates. We intend to communicate our concern with the difference in this rate and the problem it has caused in this area to the commission currently studying the social security issue.

In Senator Dole's introductory remarks to S. 2369, he invited comments with respect to procedural issues which contributed to the controversy in employment tax audits. We have studied those issues carefully. All tax assessments in our system are and should be retroactive. However, the SECA and income tax offset problem, which exists in employment tax cases does present a matter for concern particularly where a taxpayer had a reasonable basis for classifying a worker as an independent contractor. One approach to consider, for a limited class of taxpayers, would be to provide that where a taxpayer had a reasonable basis to rely on judicial precedent or published rulings relating to the taxpayer's industry and had complied with all reporting requirements, the taxpayer's liability would be limited to the employer portion of the FICA and FUTA taxes, plus a low flat percentage of the income taxes that should have been withheld. A concomitant adjustment to the coverage of the workers for benefit purposes might also be needed. We are hesitant, however, to establish any precedent for abating retroactive assessments, and we would not extend this type of relief to other than a narrowly drawn class of payor. It is important not to erode the consequences of inappropriate classification to such an extent that employers will be willing to take the risk of misclassifying workers. We would like to work with the committee further on that point.

In summary, Mr. Chairman, we would like to restate the point that was made at the outset. In dealing with the employee-independent contractor issue, our principal concern must be one of compliance. We do support the adoption of a safe harbor provision to clarify the tax status of workers for employment tax purposes, if the safe harbor is carefully drawn and is accompanied by significantly increased compliance measures. We think, generally, the common law is adequate to deal with workers in all other instances so long as there is some relief from the retroactive assessments for taxpayers who had a reasonable basis for classifying their workers as independent contractors.

Thank you.

[The prepared statement follows:]

For Release Upon Delivery
Expected at 2:00 p.m.
April 26, 1982

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE

Mr. Chairman and Members of this Committee:

I am pleased to be here today to present the views of the Treasury Department on S. 2369, the "Independent Contractor Tax Classification and Compliance Act of 1982." I am accompanied by Percy Woodard, the Assistant Commissioner (Examination) of the Internal Revenue Service.

S. 2369 would establish a statutory safe harbor which guarantees independent contractor status where five requirements are satisfied. At the same time, the common law would be retained for determining the employment tax status of taxpayers who do not meet the safe harbor. In addition, the bill would strengthen information reporting through substantially increased penalties, and would expand reporting by direct sellers.

OVERVIEW

Because the moratorium on the reclassification and issuance of regulations and rulings regarding the status of individuals for employment tax purposes expires on June 30, 1982, I agree with Senator Dole and his cosponsors that renewed consideration of this pressing issue is imperative. The present moratorium has only delayed a solution to the problem. Both taxpayers and tax administrators will benefit from its resolution.

In dealing with the employee-independent contractor issue, our principal concern is the low compliance that independent contractors as a group have shown with respect to both income and social security taxes. Noncompliance with our tax laws is a serious and growing problem. In this time of unprecedented fiscal austerity, we must take all available measures to prevent taxpayers from underreporting their income or overstating deductions or exemptions claimed on filed returns.

In 1979, the Internal Revenue Service undertook a study of the income tax and social security tax compliance of independent contractors. This 1979 Employer/Independent Contractor Compliance Study has been the subject of much discussion and criticism. Even if the criticism were justified, however, the results of that study indicate such significant noncompliance that its basic conclusion cannot be overlooked.

The 1979 study showed substantial underreporting for income tax purposes and even greater underreporting for social security purposes among those workers studied. For income tax purposes, about 78 percent of the income that should have been shown on returns was reported. In terms of taxes due, the 78 percent of reported income resulted in the collection of about 85 percent of the total tax liability due. Thus, approximately 22 percent of the income that should have been reported -- more than $1 out of each $5 -- was not reported, and 15 percent of income tax liabilities was not paid. Significantly, almost 45 percent of the workers in the study reported absolutely none of the income they earned as to which there was no withholding. As these figures indicate, nonreporting predominantly occurred among workers with smaller amounts of payments.

With respect to social security taxes, noncompliance was even greater. In total dollar terms, 69 percent of income was reported and 69 percent of social security taxes due were paid; thus noncompliance was 31 percent. Most disturbing, however, 58 percent of the workers did not report any of their self-employment income for social security purposes.

We cannot afford this high rate of noncompliance among independent contractors. Compliance measures do not impose new taxes; they merely ensure collection of taxes otherwise due. One obvious question, then, is how to improve the compliance of independent contractors. Although improving compliance is and should be the goal of any legislation in this area, the controversy over independent contractors has focused on another question: what is the definition of "independent contractor"? Although these two questions are linked, they are not identical -- if we correctly define the term "independent contractor," we still are faced with the question of achieving the best compliance within that group.

DISCUSSION OF S. 2369

Definition of Independent Contractor and Safe Harbor Test

Under the Internal Revenue Code, compensation is subject to withholding of income and employment taxes only if an employer-employee relationship exists under common law. Also, social security (FICA) and Federal unemployment (FUTA) taxes are due only if such employer-employee relationship exists. For income tax purposes, an employee is subject to withholding at graduated rates, while a self-employed individual makes quarterly estimated tax payments and the payor does not withhold. It is this disparity in collection which has put such pressure on the definition of independent contractor.

A worker is considered an employee under the common law when the person for whom services are performed has the right to control and direct the individual, not only as to the result but also as to the details and means by which the result is to be accomplished. Some 20 factors are applied to determine whether the requisite control exists; thus, determinations of employment status are heavily dependent on the specific facts of the individual case.

In many cases applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers and reasonable persons may differ as to the correct classification. Common law concepts initially developed in England as a way to determine when a master would be liable for the torts of his servant. Different criteria for determining control have been emphasized by different courts, so that no one factor is deemed to be determinative.

Although the independent contractor dispute has been cast in terms of whether the payor has the right to exercise control of the worker, that historical development need not be determinative of whether withholding at graduated rates is appropriate for a particular worker. If a worker's gross remuneration approximates his net income, withholding at graduated rates would accurately collect the correct amount of tax. Indeed, from the standpoint of the worker, withholding is the most convenient and least disruptive method of satisfying his tax obligation. On the other hand, if a worker's net income departs substantially from his gross income, the current system of withholding would produce overwithholding and would probably not be an accurate or desirable tax collection method. Moreover, if an individual works for many payors, withholding, to be accurate, presents administrative problems.

If a safe harbor definition of independent contractor will exempt a worker from the withholding system applicable to employees, the elements of that safe harbor should attempt to isolate and cover cases in which withholding on gross remuneration would not be sensible. Items such as substantial investment or unreimbursed expenses are key, while conditions of employment and control over those conditions, even though they often indicate independence, may not be determinative or even germane, except to show the administrative feasibility of withholding.

The relationship between a safe harbor and retention of common law is also crucial. A statutory safe harbor, properly drawn, would provide certainty as to their independent contractor status to workers and those for whom they perform services. But no safe harbor, however well conceived, could purport to cover all independent contractor relationships without sweeping into the safe harbor many people who are clearly employees, as well as many others whose status may be debatable. In our view the common law provides sufficient flexibility to deal with a myriad of work relationships.

A balanced approach to classification, then, should provide an appropriate but narrow safe harbor while retaining the common law to deal with taxpayers who do not meet the specific statutory provisions. In our view, however, the safe harbor of S. 2369 does or could include virtually all cases in dispute at the enactment of the moratorium. This could exacerbate the serious compliance problem that exists under current law.

S. 2369 would add a new section 3508 to the Internal Revenue Code which, if certain specified conditions were met with respect to services performed by an individual, would treat the service as being performed by other than an employee, and treat the person for whom the service is performed (the "service-recipient") as other than an employer. This provision is elective; it will apply only where the service-recipient supplies a written contract and notice of tax responsibilities to the worker prior to the service being performed and only if the service-recipient complies with information reporting requirements.

To qualify under the safe harbor provided in S. 2369, an individual must meet all three of the following additional requirements:

(1) Control of hours worked test -- The individual must control the aggregate number of hours worked and substantially all of the scheduling of the hours worked;

(2) Place of business test -- If the individual has a principal place of business, it cannot be provided by the service-recipient unless the individual pays a fair rental for it (incidental use of the service-recipient's premises will not disqualify an individual);

(3) Investment or income fluctuation test -- The individual must either (a) have an investment in tangible assets which are of significant value in the performance of the service and a substantial economic investment in light of the remuneration received, or (b) risk income fluctuation because more than 90 percent of the remuneration is directly related to sales or other output rather than to the number of hours worked.

I would like to comment on each of these tests.

Control of Hours Worked Test. The tests making up a safe harbor should be designed to indicate whether withholding on a worker's gross remuneration is accurate. In our view control of a worker's hours is seldom relevant to this determination; nevertheless, it is an important factor under common law and is not inappropriate to include in a safe harbor.

The bill makes clear that an individual can satisfy the control of hours test even though control may be limited as a result of (i) government regulations, operating procedures and specifications with which the service-recipient must comply, (ii) coordination of the services with other services so long as such coordination is done by a person other than the service-recipient, or (iii) control of access to premises by the service-recipient. With these qualifications, the control of hours test in the bill is easily met in most instances. The line between control of hours and control of access to premises or work sites can be a fine one. If a safe harbor is to be clear and easily administered -- that is, safe -- the tests for it must be relatively objective. Control of hours is difficult to determine and subject to manipulation. If this test is included, it should be more tightly drawn.

Place of Business Test -- We agree that an investigation of a taxpayer's investment in his business can be a surrogate for determining whether his gross remuneration approximates his net income. We thus agree that a place of business test is appropriate, provided that the test is met only if there is a place of business which represents a substantial investment. If the place of business is at the taxpayer's home, it must qualify under section 280A of the Code. Furthermore, the place of business should be separate from that of the service-recipient. Allowing an individual to satisfy the safe harbor even though the place of work is provided by the service-recipient could be subject to manipulation. Many existing compensation arrangements could easily be modified to meet this requirement. It should be clarified that a percentage of commissions, for example, could not be designated as "fair rental," and that a fixed dollar payment would be needed as an indication that the payee bore some risk.

Investment or Income Fluctuation Test -- The third test of the safe harbor rules in S. 2369 is one designed to determine whether a worker is "economically independent" because he has a substantial investment in assets or because he risks income fluctuation. We believe that the investment in assets test in S. 2369 provides sufficient flexibility to cover instances in which individuals have substantial capital invested in their businesses. It is important, however, that situations in which the property either is leased from or financed by the service-recipient be carefully circumscribed, so that only arm's length arrangements could meet this test. Thus, a lease term must be significant in relation to an asset's useful life; assets which are leased on a short-term or per job basis should not be taken into account.

Turning to the income fluctuation test in the bill, it should be made clear that if remuneration is provided in the form of guaranteed amounts, reimbursed expenses or other benefits, this test could not be met. The test is meaningless if it does not insure that the worker bear some risk of loss. Moreover, we think that an income fluctuation test raises questions from a compliance and administrative standpoint. If the worker bears a risk of loss but does not have significant unreimbursed expenses, withholding under the current system may be feasible, especially if the worker has a continuing relationship with a single payor. This could be true if the taxpayer's occupation is not subject to cyclical downturns or other recurring events that would cause his income to fluctuate widely within a year. We think that a more meaningful test would be the amount of the individual's unreimbursed expenses of a particular type, such as payroll expenses, supplies, or the cost of goods sold, in relation to his income. Where a worker has substantial unreimbursed expenses which would cause withholding to overstate his periodic tax payments, safe harbor treatment would be justified.

To summarize our position, we support the retention of common law and a safe harbor, but the safe harbor must be tailored to include only those taxpayers for whom withholding under the current system would be most inappropriate. We think a preferable safe harbor would be one covering only cases in which an individual is paid on other than an hourly or salaried basis and meets one of the following conditions: (1) The worker maintains a principal place of business, including a part of the home qualifying under section 280A, (2) has substantial assets used in connection with the performance of the services, or (3) incurs substantial unreimbursed expenses of a particular type, such as payroll expenses, supplies, or the cost of goods sold, in performing the services. We also would adopt the requirements of S. 2369 with respect to written contracts, notice, and compliance with information reporting.

Further, we would require an "anti-switching" rule, which would prevent employers who have treated their workers as employees under current law from switching these workers to independent contractor status merely because insubstantial changes in the employment relationship could qualify under the safe harbor adopted. The possibility of switching demonstrates how important it is to craft any safe harbor carefully. However, it will not be possible even under the best circumstances to anticipate every relationship. Therefore, some protection must be provided to prevent employees with an inferior bargaining position from being switched to independent contractor status by their employers. S. 2369 recognizes this problem by providing a transition rule that would prevent this type of switching before January 1, 1983. It is appropriate that this type of switching be prevented permanently.

In addition to providing a safe harbor test, S. 2369 contains several special rules. It provides that the safe harbor will not apply to any individual described in section 3121(d)(3) of the Code (that is, certain agent-drivers, commission-drivers, full-time life insurance salesmen, home workers, and traveling or city salesmen). This provision is an appropriate recognition of the long-standing employee status of these workers and we do not oppose this provision.

Next, the bill provides that relationships failing to meet the safe harbor test would be classified under common law rules, as if the safe harbor test were not enacted. We agree that failing the safe harbor test would not create a presumption against independent contractor status.

S. 2369 also provides that qualification as an independent contractor under the safe harbor test for purposes of Federal employment taxes and withholding would create no inference with respect to other laws. This is appropriate, since the policies behind state unemployment compensation laws or labor relations acts may be very different from the policies for Federal tax purposes, even though these statutes may in many instances also rely on common law rules.

Finally, individuals who qualify under the safe harbor as independent contractors would be denied statutory employee benefits, including the exclusion for employer provided group term life insurance, death benefits, accident and health benefits, group legal services, education assistance plans, and pension, profit-sharing, stock bonus or annuity plans. The bill clarifies that these individuals would be eligible for Keogh plans, however. Again, this is an appropriate recognition that independent contractors are self-employed businesses and that employee benefits should not be available.

Information Reporting

The remainder of S. 2369 deals with the question of how to raise the compliance of those workers who are classified as independent contractors and who are thereby exempt from withholding under current law. I will confine my remarks on these provisions to the approach adopted in the bill.

As under current law, S. 2369 would require that persons engaged in a trade or business file information returns on remuneration in excess of $600 during the calendar year paid to any person for services. However, the bill would expand information reporting by the direct sales industry. Anyone in the trade or business of selling consumer products to any buyer on a buy-sell, deposit-commission, or any similar basis for eventual resale in the home would be required to report gross sales of $5,000 or more. However, a seller could elect instead to report remuneration (that is, commissions, bonuses, prizes, etc.) in excess of $50 paid during the calendar year. A payor making this election also would be required to supply to IRS the name and identification number of each buyer to whom the payor has sold goods of $50 or more during the calendar year.

S. 2369 would replace the present modest penalty for failure to file information returns or to supply copies to payees with a penalty of up to 5 percent of the amount of remuneration which should have been included on the return. The amount of the penalty increases in two stages, based upon the reporting agent's overall compliance rate. Failure of a direct seller who elects to supply information on sales above $50 would be subject to the penalty applicable under current law for failure to file information returns with respect to independent contractor payments -- $10 for each failure, not to exceed $25,000 during any calendar year.

S. 2369 also would extend withholding where a payee fails to provide a taxpayer identification number to a payor, or where if the IRS determines that the taxpayer identification number provided is incorrect. This provision also is contained in S. 2198, "The Taxpayer Compliance Improvement Act of 1982."

We recognize that information reporting on taxable transactions is valuable both to the government -- to enable it to check the information reported by taxpayers through matching and other means -- and to the vast majority of taxpayers who conscientiously attempt to report all of their income. We have several comments and suggestions regarding the changes with respect to information reporting that are contained in S. 2369.

Under current law, the threshold for information reporting is $600, which is largely unchanged by S. 2369. It would be appropriate to consider substantially lowering this figure with respect to payments for services. Indeed, in the area of interest and dividends, the reporting threshold is currently $10, and wages are reported from the first dollar earned. Compliance would improve if taxpayers knew that their payments had been reported to the Internal Revenue Service.

We welcome the recognition in S. 2369 that information reporting by direct sellers should be expanded. As you know, initially our view was that information reporting on a specific dollar amount of gross sales would be of use to the Internal Revenue Service both in identifying individuals in this industry with self-employment income and in verifying gross receipts reportable on Schedule C. However, the Service has been considering what information from the direct selling industry it could best use to determine accurate tax liabilities in this area. After close examination, and taking into account the difficulties in comparing gross sales with amounts reported by taxpayers on their returns, the Service now has concluded that they will better be able to utilize mandatory information reporting on commissions, bonuses, prizes, etc., in excess of $100 in the calendar year. At the same time, the Service must have some means to obtain information on those sellers who are compensated only by the difference in the price at which they purchase goods and then resell them for use in the home. We therefore support reporting of the name, address, and taxpayer identification number for gross purchases in excess of $100 annually. In addition, while the penalty for failure to file a return of this type must be a flat dollar amount per failure, we think the maximum limit on the penalty should be at least $50,000.

We do not think that an exception to the normal unlimited statute of limitations for failure to file a return should be made for information returns required to be filed with respect to independent contractors, as S. 2369 would do. Recordkeeping requirements exist for all taxpayers. We believe that this provision should be dropped from the bill.

With respect to the penalties contained in S. 2369, we have the following comments. Penalties in a voluntary compliance system must both deter behavior that would impair the system and, at the same time, take into account reasonable errors or omissions made in good faith. This second element is particularly important given the difficult questions of classification in determining employee status under the tax laws. We believe that a percentage penalty for failure to file or to furnish information returns relating to independent contractors is appropriate, as S. 2369 would provide. However, the step increases in the penalty rate based upon the reporting agent's overall compliance is complex and could prove difficult to administer. It could only be imposed after the reporting requirements of a payor are fully determined for a calendar year, which delays and adds uncertainty to the determination of whether a penalty will be due and at which level it will be imposed. Although we appreciate that its purpose is to provide a stiffer penalty on large payors for noncompliance, we think a penalty computed as a percentage of compensation not reported is adequate.

Finally, imposing withholding where there is a missing or incorrect taxpayer identification number is an appropriate and desirable sanction, although we understand that there may be some technical questions as to how this can best be accomplished. Defective information reports are in many cases worthless to the Service, and those that are corrected are done at substantial expense. By implementing source withholding on persons not willing to provide correct numbers, this provision will place the onus of correct information reporting on the person best able to insure that the reporting is accurate.

ADDITIONAL COMMENTS

FICA/SECA Differential

Significant economic incentives encourage payors and workers to seek independent contractor status, apart from the exemption from income tax withholding. The social security taxes imposed on independent contractors under the self-employment contributions act (SECA) are lower than the taxes an employee must bear under the Federal insurance contributions act (FICA). Even though one-half of the FICA tax is paid by the employer, it is generally agreed that this burden is in fact borne by the employee in the form of lower wages. In 1982, FICA taxes on wages are a combined rate of 13.4 percent on the first $32,400, while self-employment income (income net of expenses) of $32,400 is subject to SECA tax of 9.35 percent. Based on similar earnings histories, independent contractors and other self-employed persons receive the same social security benefits as employees, even though they contribute significantly less to the trust funds.

It would be possible to reduce the tax advantages inherent in independent contractor status by more closely conforming the FICA and SECA tax rates. A change of this nature could help neutralize the decision whether to hire an independent contractor or an employee and relieve pressure on the question of employment status. Correcting the disparity between the FICA and SECA tax rates should be given consideration in the future as part of the broader issue of social security financing. The Treasury Department intends to communicate our concerns in this area to the commission currently studying the social security issue.

Procedural Issues in Employment Tax Audits

In his introductory remarks to S. 2369, Senator Dole invited comments with respect to procedural issues which contributed to the controversy in employment tax audits. Prior to the adoption of section 530 of the Revenue Act of 1978, when the Internal Revenue Service determined on audit that workers should have been classified as employees rather than as independent contractors, the employer was liable for the employer share of FICA and Federal unemployment tax (FUTA) payments and for the income and FICA taxes which should have been withheld from the employee, for all past years for which the statute of limitations had not expired. In addition, reclassification could call into question the status of the employer's pension plan. Furthermore, the liability for income taxes which should have been withheld could be abated only if the payor could prove that the workers had in fact paid their income taxes, which frequently was impossible because in many instances the workers could not be located. Even when workers could be located, the burden of establishing their tax liability often was time consuming and costly. Moreover, the payor's liability for FICA taxes which should have been withheld could not be offset by any SECA taxes paid by the worker (assuming the SECA tax had in fact been paid), unless a worker was barred from filing a claim for refund by the statute of limitations. As a result, liabilities for taxes not withheld could result in more than the actual tax liability being collected but neither the payor nor the Internal Revenue Service had an adequate means for determining how to abate the tax.

All tax assessments in our system are, and should be, retroactive. However, the SECA and income tax offset problem in employment tax cases does present a matter for concern, particularly for a taxpayer who had a reasonable basis for classifying a worker as an independent contractor. One approach to be considered, for a limited class of taxpayers, would be to provide that where a taxpayer had a reasonable basis to rely on judicial precedent or published rulings relating to the taxpayer's industry and had complied with all reporting requirements, the taxpayer's liability would be limited to the employer portion of the FICA tax and FUTA, plus a low flat percentage of the income taxes that should have been withheld. A concomitant adjustment to the coverage of the workers for benefit purposes also might be needed. We are hesitant, however, to establish any precedent for abating retroactive assessments, and we would not extend this type of relief to other than a narrowly drawn class of payors. In addition, it is important not to erode the consequences of inappropriate classification to such an extent that employers will be willing to take the risk of misclassifying workers. We would be happy to work with this Committee to consider further an appropriate provision in this area.

It has been suggested that another way to deal with the harsh retroactive assessment problem would be to provide a mechanism for declaratory judgment relief or prepayment review in the Tax Court. At this point, expanding the Tax Court jurisdiction to employment tax cases would be very unwise. The Tax Court docket is already vastly overburdened. Existing procedures in employment tax cases already provide access for taxpayers to the Court of Claims or district courts based upon payment of a small fraction of the amount actually at issue. Providing Tax Court jurisdiction would not facilitate review. Moreover, the benefits of employee status are retroactive. A worker treated as an employee will be entitled to benefits regardless of whether FICA has been withheld. Thus, postponing liability until a declaratory judgment proceeding is resolved could prove costly to the trust funds.

SUMMARY

In dealing with the employee-independent contractor issue, our principal concern remains compliance. The Treasury Department supports the adoption of a safe harbor provision to clarify the tax status of workers for employment tax purposes, if this provision is carefully drawn and accompanied by significantly increased compliance measures. We think that the common law is adequate to deal with workers in all other instances, so long as some relief from retroactive assessments is considered for those taxpayers with a reasonable basis for classification.

Senator GRASSLEY. Thank you very much for your testimony. My first question deals with a possibility. Let's suppose that the Dole bill or some other bill didn't pass in this area. Will there be a sudden upswing in audit activity when the moratorium expires on June 30?

Secretary CHAPOTON. Mr. Chairman, I don't think it is correct to say there would be a sudden upswing in audit activity. If that occurs, I think we should try to work out some type of safe harbors, along the lines I've discussed, in a set of regulations, while keeping the staff of the Committee fully informed. We would then apply those regulations in future audits.

Senator GRASSLEY. In your comments on the procedural aspects of this bill, you did deal with the possibility that if the common law tests are a fallback determination if a taxpayer does not meet the safe harbor tests. Again, let's suppose we do not enact Senator Dole's bill and the moratorium is not extended. Do you think the IRS can and will administer the common law test in a uniform way nationwide to avoid the criticism that has been leveled at the Agency during that period in the 1960s and the 1970s when they increased audits?

Secretary CHAPOTON. I think so. That's why I say I think we should come forward with regulations and certainly attempt to get more uniformity. That was, I think, a valid criticism.

Senator GRASSLEY. Can the IRS administer the Dole safe harbor provisions in a more uniform manner than it did administering the common law standard?

Secretary CHAPOTON. Any safe harbor provisions will result in greater uniformity. We would like greater specificity, as I have outlined in the testimony, in some areas of the safe harbor. Clearly, the safe harbors are desirable and will add more uniformity in administration.

Senator GRASSLEY. Are there any other acceptable legislative solutions to this problem short of granting safe harbor?

Secretary CHAPOTON. Well, the other is the bright line test, which would take a rule such as a safe harbor and say on one side you are an employee for tax purposes, and withholding is required; on the other side you are not. Indeed, from a strictly administrative standpoint, that might well be desirable. Given today's situation, however, I think a safe harbor test is probably more practical.

Senator GRASSLEY. In your testimony your referred to anti-switching. Do you see this as a problem?

Secretary CHAPOTON. Yes, definitely. We do see that as a problem because it is going to be difficult in designing a safe harbor test to envision every situation. There will clearly be an incentive, because of the differences in treatment and the economic differences, to independent contractor status employee and employer status. There will, indeed, be an incentive to change the terms of employment slightly if it will bring you under the safe harbor. We think if withholding is in place for an arrangement now, from both the bill and from our standpoint, we are not trying to move people out of the withholding classification into an independent contractor status.

Senator GRASSLEY. Some individuals classified as independent contractors under common law might not fall within the safe harbor. You have already addressed the fact that Senator Dole's bill has an inference clause that states that failure to fall within the safe harbor does not prejudice an individual's right to be considered an independent contractor under common law. But my question is will the IRS agents, in your judgment, look at the common law determination fairly after an individual does not fall within the safe harbor or will there be a stricter scrutiny? Or maybe to put it another way is Senator Dole's bill clear enough? If not, how can you write it so that you know that this won't happen?

Secretary CHAPOTON. I think, Senator Grassley, it is virtually impossible to cover every case. A legitimate concern is that once you have a safe harbor and you fall outside of it, to state that no inference is to be drawn from that is wise. Though, there is always concern that once you are outside a safe harbor, there may be some inference, there should not be. We have made the point, and I think the point should be made again, that that would be determined strictly under common law principles.

Senator GRASSLEY. My concern is whether or not there would be a situation created by this bill in which those not covered by safe harbor would not be in a "worse" position than they are today using the common law tests.

Secretary CHAPOTON. They should not be.

Senator GRASSLEY. Well, I know that's our intention, but I want some assurance that they won't be from the practical aspect of administering the law.

Secretary CHAPOTON. Well, I don't think there would or should be any effort to suddenly go after and change classifications in the area that falls outside the safe harbor. I think we could take care to see that that is not done. We cannot, however, prevent some disputes when you apply common law with its many factors. There are some 20 factors involved. There will clearly be some disputes. Indeed, I think there should be some disputes with the Internal Revenue Service to clear up the areas that are not resolved. The Internal Revenue Service is charged with enforcing the law. The law will depend upon common law principles for determining whether the independent contractor status exists. We do know compliance is certainly highest where withholding is imposed. Both of us, I think, would want the Internal Revenue Service to require employee status unless there was a showing that it was not appropriate.

Senator GRASSLEY. My last question deals with a point that you already raised in your testimony in regard to workers retroactively being treated as employees as opposed to independent contractors. You addressed the tax liability aspects of that reclassification, but, how would reclassification affect Keogh and other qualified benefit plans?

Secretary CHAPOTON. The part addressed in the testimony was the additional tax liability that could arise if the classification is moved from a claimed independent contractor status to an employee status. That status does, indeed, determine rights under employment plans or under self-employed Keogh-type plans.

The question is whether an employee moved into independent contractor status could be disqualifed for pension plan benefits, or if he is moved into employee status, should he qualify under the plan. Treatment as an employee could, indeed, make the plan fail coverage requirements because there is a minimum number of employees that must be covered under the qualified plan rules.

Senator, we have been studying those questions. Admittedly there could be some problems there. There are definitely some administrative problems that exist. We don't have all the answers. The IRS, I think, could administer the plan so as not to disqualify it retroactively. The employer probably would have to cover the employee for the future, for example, if a worker is moved into employee status. But there are a number of problems which we would need to deal with in that area.

Senator GRASSLEY. Then I suppose this is something we ought to have an answer to in regard to this bill. Could that be handled by legislation?

Secretary CHAPOTON. I think it could be handled by regulations. I don't, offhand, see a requirement for legislation.

Senator GRASSLEY. Senator Dole.

Senator DOLE. I hope, first of all, that we don't have to extend the moratorium. I think we have enough time. It is only April. And maybe we can still put a package together. If we put a package together, we would have plenty of time for this. But if we don't do that, what revenue effects might be—if we continue to extend the moratorium on certain IRS activity? Do you have any rough estimates?

Secretary CHAPOTON. We have some preliminary estimates on S. 2369. Revenue estimates on extending the moratorium have some difficulty, Senator Dole. We basically assume compliance with the law, for the most part. The revenue estimates would deal mostly with the difference in tax rates, the FICA rate from the SECA rate. It is difficult for us to estimate.

Senator DOLE. You raised a number of questions in your statement about areas that you think we should tighten up on our proposal. We appreciate those suggestions. And we would be happy to work with Treasury, because we want it to be meaningful. We want it to be fair. But also we want it to be meaningful. We don't have any intention of extending the moratorium because once that is done, the pressure is off to do anything in this area. So it would be my hope that the committee would not even consider that. That is only my view. There are 19 others on the committee who might have a different view.

Secretary CHAPOTON. We would certainly hope that is the case, Senator. We will be happy to work diligently with the committee because extending the moratorium is the least attractive of all alternatives. It continues an uncertain situation and it takes pressure off to finding a solution of a problem that definitely needs solving.

Senator DOLE. Not just from Treasury's standpoint, but I think a lot of people who want to be fairly treated as independent contractors. It seems to me the climate is right for making that step. And there may be areas that we have disagreement on, but if we find they are justifiable maybe we can work them out. If they are not, maybe we shouldn't. So I just suggest that we hope we can move quickly on this as separate legislation or as a part of the compliance package, which it was intended to be, but it wasn't quite ready to be introduced at that time. I hope the entire compliance package could become part of the overall budget proposal which is now, and has been under consideration, forever it seems.

But once the compliance provisions of this bill take full effect in 1984, then we start getting a positive impact from the standpoint of revenues. Not a great deal, but the estimates are at least on the positive side. And as I understand the revenue losses, due to any possible switchovers, would result from the fact that the self-employment tax is less than the combined employee-employer social security rate, I think, as you pointed out in your statement.

Does that comport with your analysis of the revenue effects?

Secretary **Chapoton**. That comports with our analysis. S. 2369 would move some employees into independent contractor status. We thus would show a short-term revenue loss from this bill.

Senator **Dole**. And I think it's fair to say it is not a part of any package, but there has been some discussion that I have overheard that there might be some movement to increase the self-employment rate.

Secretary **Chapoton**. Let me add to my last statement, Senator Dole. The reason there would be a short term loss is that the SECA tax is collected later. It is not withheld. So most of it would be picked up. The remaining difference would be the difference in rate.

As for the other question, certainly there should be some consideration to bringing the two rates together.

Senator **Dole**. I have a number of other questions, but I think we are going to be working with you in any event and these questions will be raised. One is with reference to the so-called anti-switchover provision. It's possible—again, anything is possible—that you could have a salaried secretary in a real estate office who became a salesperson working exclusively on a commission basis or was hired by some other real estate firm. And I would assume that we would have to make some allowance for that.

Secretary **Chapoton**. You describe an actual change in condition of employment. An antiswitching rule certainly should take that into account.

Senator **Dole**. Well, we appreciate your testimony, and we will be working closely and quickly on this because I think it's important that we do it as expeditiously as possible so we can beat that deadline. Thank you.

Senator **Grassley**. One more question. In your judgment is if necessary to provide a quick inexpensive way for business to make certain it is classifying its workers properly. Should we consider an expedited declaratory judgment proceeding for that purpose?

Secretary **Chapoton**. We have considered that. I mention that in our written statement, Mr. Chairman. We are very reluctant to recommend further declaratory judgment proceedings in the Tax Court. The workload of the Tax Court has become very severe. There is a procedure for the taxpayer to pay a small amount of the tax, and take it to the Court of Claims or the district court. We would not like the declaratory judgment process expanded at this time.

Senator **Grassley**. Thank you very much for your testimony.

Secretary **Chapoton**. Thank you, Mr. Chairman.

Senator **Grassley**. Our next witness is Daniel F. Stanton, who is Deputy Director of the General Government Division of the General Accounting Office here in Washington, D.C.

Mr. Stanton, do you want to introduce the people with you?

Mr. **Stanton**. Yes, Mr. Chairman.

STATEMENT OF DANIEL F. STANTON, DEPUTY DIRECTOR, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Mr. **Stanton**. To my right is Randy Conley, assistant manager in our Detroit regional office. He supervised the work we did in the contract area several years ago.

To my left is Dan Harris who is group director of our work in the tax administration area.

With your permission, Mr. Chairman, I would summarize my statement.

Senator **Grassley**. Yes. Please do. I ought to suggest at this point for everybody who is going to be testifying that as a matter of normal procedure your entire written statement will be printed in the record as submitted. We would appreciate it very much if you would summarize; particularly considering the fact that we do have several panels.

Please proceed.

Mr. **Stanton**. We are pleased to be here today to assist your subcommittee in considering S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982. The bill seeks to resolve the issues which surround the classification of workers as either employees or self-employed for Federal tax purposes.

Our testimony is based primarily on work we have done in the past several years relating directly and indirectly to the subject of independent contractors. We have reported and testified extensively on taxpayer compliance and the unreported income problem, including the problem involving independent contractors.

Mr. Chairman, we support the objectives and intent of S. 2369. It should ease the problems associated with classifying workers as employees or as independent contractors. Businesses will be able to make worker status determinations with more certainty and have less fear of unexpected and large retroactive tax assessments. In addition, the bill provides tools which should help the IRS improve independent contractor compliance with the tax laws.

The bill requires that to meet the economically independent aspects of the safe harbor provision, a worker must either risk income fluctuations or have a substantial investment in tangible assets used in performing the service. We believe the income fluctuation aspect may be too broad. For example, a worker who gets paid commissions could have significant fluctuations in income. These workers may be employees under common law and yet qualify as independent contractors under the safe harbor provisions of S. 2369, a result seemingly contrary to the intent of the bill. We suggest, therefore, that the income fluctuation test be replaced by a test of a worker's risk of suffering a loss as well as making a profit.

Although S. 2369 should result in fewer IRS reclassifications of workers and thus fewer retroactive assessments of employment taxes, some reclassifications and retroactive assessments will still occur. The likelihood of IRS reclassifications and retroactive assessments could perhaps be further reduced by Treasury issuing timely and explicit implementing regulations after enactment of the bill. It is important that such regulations clearly define and explain the safe harbor provisions, and contain several examples of the applicability of the criteria.

When retroactive assessments are made, the problem of double taxation can exist in certain situations. Some legislative and administrative remedies are thus needed. Double taxation occurs when the employer and the employee pay taxes on the same income. To help alleviate this problem, we recommended in our 1977 report that the Congress amend section 6521 of the Internal Revenue Code to authorize IRS to reduce the employee's portion of FICA taxes assessed against the employers by an appropriate portion of the amount of SECA taxes paid by reclassified employees for the open statute years.

The Congress has not yet acted upon that recommendation. In the interest of equity, we still think it should.

We also support the bill because it should enhance independent contractors' compliance with the tax laws by emphasizing information reporting and providing penalties to insure that the information reported is accurate and complete. However, the additional information reports and penalties will increase IRS' workload at a time when overall compliance is declining and IRS resources are not keeping pace. In this regard, we have repeatedly stressed the importance of having payers submit information reports on computer tapes instead of on paper, and repeatedly supported the need for increased IRS resources.

In conclusion, Mr. Chairman, we support S. 2369 and its principal concerns: clarifying the standards for determining worker status for federal tax purposes and improving independent contractors' compliance with the tax laws. We, too, think it is time to end the moratorium and provide more certainty for businesses on deciding whether a worker is an employee or self-employed. Although the bill will increase IRS' workload at a time when its resources are spread thin, S. 2369 like S. 2198 would enhance IRS' efforts to deal with the tax compliance gap. Perhaps more important than any of their specific compliance provisions, S. 2369 and S. 2198 would send to the public that the Congress and the IRS are taking tough measures to reduce tax cheating and the burden it places on honest taxpayers.

Mr. Chairman, we would be pleased to respond to any questions you may have.

[The prepared statement follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 2:00 P.M. EDT
MONDAY, APRIL 26, 1982

STATEMENT OF
DANIEL F. STANTON, DEPUTY DIRECTOR,
GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE
SENATE COMMITTEE ON FINANCE
ON
SENATE BILL 2369, INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your subcommittee in considering S.2369, the Independent Contractor Tax Classification and Compliance Act of 1982. The bill seeks to resolve the issues which surround the classification of workers as either employees or self-employed for Federal tax purposes. These issues led to the Congress' imposing a 3-1/2 year moratorium on employee-independent contractor determinations by the Internal Revenue Service (IRS). That moratorium is due to expire on June 30, 1982.

Our testimony is based primarily on work we have done in the past several years relating directly and indirectly to the subject of independent contractors. In late 1977, we issued a report which dealt with (1) the difficulties faced by employers and IRS in determining who is an employee and who is self-employed and (2) the problems associated with retroactive assessments against employers who IRS believed had misclassified employees as independent contractors. 1/ The report recognized the need and recommended standards for clarifying the classification rules so that businesses could more accurately make employee and self-employed determinations. In a 1978 report, we made various recommendations for improving IRS' audits of individual returns as they relate to the correct payment of social security taxes, particularly by self-employed persons. 2/ In 1979 testimony before the House Ways and Means Subcommittee on Select Revenue Measures, we reaffirmed the need to clarify the rules for determining employer-employee relationships. 3/ We have also reported and testified extensively on taxpayer compliance and the unreported income problem, including the problem involving independent contractors.

1/"Tax Treatment Of Employees And Self-Employed Persons By The Internal Revenue Service: Problems And Solutions" (GGD-77-88, Nov. 21, 1977).

2/"Additional IRS Actions Needed To Make Sure That Individuals Pay The Correct Social Security Tax" (GGD-78-70, Aug. 15, 1978).

3/Statement of Richard L. Fogel, Associate Director, General Government Division, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, on Compliance Problems of Independent Contractors.

Mr. Chairman, we support the objectives and intent of S.2369. It should ease the problems associated with classifying workers as employees or as independent contractors. Businesses will be able to make worker status determinations with more certainty and have less fear of unexpected and large retroactive tax assessments. In addition, the bill provides tools which should help IRS improve independent contractor compliance with the tax laws.

S.2369, however, will not eliminate the need for IRS reclassifications and retroactive assessments, and problems associated with those actions will continue to exist. Therefore, some legislative and administrative changes will be needed, particularly to reduce the potential for double taxation. In addition, IRS will be faced with an increased workload generated by the information reporting provisions of the bill.

S.2369 CLARIFIES THE PROCEDURES FOR CLASSIFYING WORKERS, BUT SOME RECLASSIFICATIONS AND RETROACTIVE ASSESSMENTS WILL STILL OCCUR

S.2369 clarifies the standards used in determining if workers are employees or independent contractors for Federal employment tax purposes. While there are some differences between S.2369 and the recommendations we made in 1977, S.2369 accomplishes the overall purpose of clarifying the circumstances under which a worker should be classified as an employee or an independent contractor. The bill's safe harbor provision provides standards and tests for deciding whether a worker is an employee or an independent contractor for Federal tax purposes.

We generally agree with the standards contained in the bill. However, the subcommittee may want to consider a modification to the test for ensuring economic independence.

S.2369 requires that to meet the economically independent aspect of the safe harbor provision, a worker must either risk income fluctuations or have a substantial investment in tangible assets used in performing the service. We believe the income fluctuation aspect may be too broad. For example, any worker who gets paid commissions or is involved in piecework could have significant fluctuations in income. These workers may be employees under common law and yet qualify as independent contractors under the safe harbor provision of S.2369, a result seemingly contrary to the intent of the bill. We suggest, therefore, that the income fluctuation test be replaced by a test of a worker's risk of suffering a loss as well as making a profit.

Although S.2369 should result in fewer IRS reclassifications of workers and, thus, fewer retroactive assessments of employment taxes, some reclassifications and retroactive assessments will still occur. In this regard, while the bill's safe harbor provision provides greater certainty, there will no doubt be instances where IRS and businesses disagree on the applicability of the provision. Also, many cases will continue to be resolved under the common law criteria because some workers will not qualify under the safe harbor provision or will choose the option of common law as an alternative test. Thus, the problem of businesses being assessed retroactively--even if they had acted reasonably in making the worker status determination--will still exist, although on a smaller scale.

The likelihood of IRS reclassifications and retroactive assessments could perhaps be further reduced by Treasury's issuing timely and explicit implementing regulations after enactment of the bill. It is important that such regulations clearly define and explain the safe harbor provision and contain several examples of the applicablity of the criteria.

When retroactive assessments are made, the problem of double taxation can exist in certain cases. Some legislative and administrative remedies are thus needed. Double taxation occurs when the employer and the employee pay taxes on the same income.

IRS cannot offset the employee share of Federal Insurance Contribution Act (FICA) tax with the amount of Self-Employment Contribution Act (SECA) tax the employee paid on the same income, unless the 3-year statute of limitations period has expired. Such an offset is authorized only if the employee is prevented by law from filing for a refund of the SECA tax paid in error.

Failure to offset can result in the employee portion of social security taxes being collected twice--once from the employer as the FICA tax he or she failed to withhold and once from the employee as SECA tax paid in error. This happens because the employees often do not know that they can file for a refund of SECA tax paid. The employer's portion of the FICA tax does not represent a double payment because the tax is paid for the first time when the employer pays the tax.

On the basis of our sample of cases closed in 1975, we estimated that at least 667 employers were assessed retroactively about $2 million in FICA taxes. Of this amount, $1 million represented the employers' portion of the tax. The remaining $1 million represented the employees' portion of the tax which the employer was responsible for withholding. To the extent that the employees paid their SECA taxes while improperly classified as self-employed, a double payment of social security taxes occurred.

For example, we analyzed 5 of the employer cases in our sample. These 5 cases involved 37 employees. Our analysis showed that 24 of the 37 employees paid SECA tax on the income earned while considered self-employed. IRS assessed the five employers $6,913 for the employees' portion of the FICA taxes due on wages paid to the 37 employees. Of this amount $5,008 (72.4 percent) represented a double payment of social security taxes to the Government. The amount of the social security taxes actually due the Government was $1,905.

To help alleviate this problem, we recommended in our 1977 report that the Congress amend Section 6521 of the Internal Revenue Code to authorize IRS to reduce the employees' portion of FICA taxes assessed against employers by an appropriate portion of the amount of SECA taxes paid by reclassified employees for the open statute years. The Congress has not yet acted upon that recommendation. In the interest of equity, we still think it should.

In our 1977 report, we also recommended that to avoid double taxation IRS should use information in its files to adjust retroactive assessments. IRS opposed this recommendation contending that it would shift from the employer to IRS the whole burden of proving which employees had paid self-employment and income taxes and in what amounts. Our intent was not to shift to IRS the whole burden of proving which employees had paid SECA and income taxes. Rather, we intended that, in instances where employers had made reasonable but unsuccessful efforts to obtain employee certifications that the proper tax had been paid, the IRS agent would

(1) where possible and practical, obtain copies of tax returns for those employees from whom the employer was unable to obtain a certification;

(2) make limited checks as to the taxes reported as paid by these employees; and

(3) if justified on the basis of these checks, abate a portion of the employer's tax assessment.

We think our recommendation still merits consideration. We recognize that our recommendation would increase IRS' costs without producing additional revenue. Our concern in this instance, however, is more with the inequity of double taxation. Also, the cost to implement the recommendation should be less after S.2369 is enacted. S.2369 should reduce the number of reclassifications and retroactive assessments and, thus, the number of potential double taxation situations. This, in turn, should result in fewer cases that IRS would need to research.

S.2369 SHOULD IMPROVE INDEPENDENT CONTRACTOR COMPLIANCE IF IRS CAN HANDLE INCREASED WORKLOAD

We also support S.2369 because it should enhance independent contractors' compliance with the tax laws by emphasizing information reporting and providing penalties to ensure that the information reported is accurate and complete. However, the additional information reports and penalties will increase IRS' workload at a time when overall compliance is declining and IRS resources are not keeping pace.

Specifically, S.2369 would expand existing information reporting requirements to include direct sellers who provide consumer goods to others for resale in the home on a buy-sell or deposit-commission basis. It also provides for stiff penalties for payers who fail, without reasonable cause, to provide the information reports to IRS or to the independent contractors. Additionally, the bill would authorize tax withholding when payees fail to provide the identification numbers IRS needs to match the information reports with filed tax returns.

As you know, Mr. Chairman, we have reported and testified extensively on the unreported income problem, including noncompliance by self-employed persons. On March 22, 1982, we testified before this subcommittee in support of S.2198, the Taxpayer Compliance Improvement Act of 1982, which, among other changes, would increase and strengthen the use of information reporting applicable to areas other than independent contractors. We also support S.2369 which is specifically targeted at independent contractors.

As with the information reporting requirements of S.2198, however, S.2369 will increase the number of information reports IRS receives, and IRS will thus have more reports to process and match against tax returns. That matching, in turn, could produce more unreported income cases to investigate. Both situations entail increased use of IRS resources which, as you know, Mr. Chairman, is a problem. In this regard, we have repeatedly stressed the importance of having payers submit information reports on computer tapes instead of on paper, and repeatedly supported the need for increased IRS resources.

S.2369 also provides various penalties designed to ensure the accuracy and completeness of information reports. Although we support the need for tougher penalties, we would like to make an observation concerning the bill's penalty provisions. While we have not had an opportunity to consider all the administrative implications, the penalty surcharge provisions of the bill may be somewhat cumbersome and time-consuming to administer--and thus less likely to be fully enforced by IRS. In this regard, in our testimony on the penalty provisions of S.2198, we pointed out that, while sufficiently high penalties are a necessary part of effectively promoting and enforcing compliance with information reporting requirements, IRS needs to more effectively identify and pursue payers who fail to submit all required information reports.

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In conclusion, Mr. Chairman, we support S.2369 and its principal concerns--clarifying the standards for determining worker status for Federal tax purposes, and improving independent contractors' compliance with the tax laws. We too think it is time to end the moratorium and provide more certainty for businesses in deciding whether a worker is an employee or self-employed.

Even with the bill's safe harbor provision, some reclassifications and retroactive assessments will still occur. In this regard, we suggest that the Congress consider our recommendation for a FICA-SECA offset to avoid the double taxation which may result in some of these instances.

Although the bill will increase IRS' workload at a time when its resources are spread thin, S.2369, like S.2198, would enhance IRS' efforts to deal with the tax compliance gap. Perhaps more important than any of their specific compliance provisions is the message S.2369 and S.2198 would send to the public--the Congress and IRS are taking tough measures to reduce tax cheating and the burden it places on honest taxpayers.

This concludes my prepared statement, Mr. Chairman. We would be pleased to answer any questions.

Senator **Grassley**. I'd like to know your views as to what extent the Dole bill is going to enhance uniformity and administerability as opposed to the common law test used prior to 1978.

Mr. **Stanton**. Well, we think it will put more certainty in the program. There is certainly need for better standards at this time. And I think there would be less uncertainty among the people as to which role they really fit in.

Senator **Grassley**. So you don't have any doubt about the fact that it is going to be more uniform?

Mr. **Stanton**. No, sir. We think it is a real improvement.

Senator **Grassley**. And easier to administer as well?

Mr. **Stanton**. Yes, sir. It definitely should be easier to administer. And there would be less retroactive adjustments.

Senator **Grassley**. Senator Dole.

Senator **Dole**. Well, I think just for the record—we have had a lot of controversy going on in the 1960's and 1970's—and I just wondered if in your investigation whether or not you have determined if both the IRS and the business pretty much were in good in trying to classify the workers. Was it a lack of clarity in the law? I remember being here a couple of years ago when the person who occupied Mr. Chapoton's place, in effect, inferred that a lot of people out there were just participating in fraudulent activity. Now that was a fairly broad statement. I think some of us noted at the time that at least we believed that much of the misunderstanding was because of lack of clarity. Have you been able to make any judgment on whether the business people or the IRS were a little overzealous in their conduct of classifying workers?

Mr. **Stanton**. Well, I think the uncertainty in the act opened the door for a lot of things to happen. I will let Mr. Conley, who supervised the work we did in this area, respond to that.

Mr. **Conley**. I think that most of what you referred to is the ambiguity of the common law. Much of that can be interpreted one way or another, depending on which way you are inclined to tilt. I think IRS, with their primary job to protect and collect the revenues, may have a conservative tilt in one direction. The self-employed or independent contractors may tilt in the other direction. Because of the ambiguity of the law, you could justify either way.

Senator **Dole**. Do you have any views on what sort of information reporting for direct sellers would provide the greatest compliance effect with the least burden of impact on the direct selling companies?

Mr. **Stanton**. You mean the two alternatives that are in the current bill?

Senator **Dole**. Yes; if you were going to try to figure out some information reporting for direct sellers that wouldn't burden them with a lot of paperwork and still be effective, do you have any suggestions on how that might best be accomplished?

Mr. **Stanton**. No, sir, I think what we have in the bill here is a very good basis at least for starters. And it should be looked at periodically and not be in concrete.

Senator **Dole**. Again, I have some additional questions that are technical in nature. And I think rather than take the present time of the witness and your assistants and the panels who are waiting, that we will discuss them with you. I trust you will be available if we need assistance.

Mr. **Stanton**. Yes, sir, we certainly will.

Senator **Dole**. Thank you.

Senator **Grassley**. That's the end of our questioning. If you get any questions in writing from any other members of the committee, we would appreciate it if you or any of the panelists to follow would quickly respond to those questions in writing as well.

Mr. **Stanton**. Yes, sir, we certainly will.

Senator **Grassley**. Our next series of witnesses is a panel consisting of Mr. Gustav J. Lehr, president of the Shelter Insurance Companies of Columbia, Mo., on behalf of the National Association of Independent Insurers, with offices in Washington, D.C.; Mr. David D. Robert, on behalf of the National Association of Realtors, offices in Washington, D.C.; and Mr. Monty Barber, vice chairman of the board of directors, and Mr. Neil H. Offen, president, the Direct Selling Association, Washington, D.C.

For those of you who have colleagues with you, I would appreciate it if you could introduce them for the record. I guess we will do it in the order in which I called, which would be Mr. Lehr, Mr. Robert, and Mr. Barber.

STATEMENT OF GUSTAV J. LEHR, PRESIDENT, SHELTER INSURANCE COMPANIES OF COLUMBIA, MO., ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, WASHINGTON, D.C.

Mr. **Lehr**. Thank you. Sitting on my left is Frank McDermott, an attorney with Hopkins & Sutter here in Washington, who also appears here in behalf of NAII.

Mr. Chairman, Senator Dole, my name is Gus Lehr. I am president of the Shelter Insurance Companies of Columbia, Mo., and a member of the board of governors of the National Association of Independent Insurers, generally referred to as the NAII.

Today, I appear on its behalf. NAII is the largest property and casualty insurance trade association in the country. First and foremost, let me state that the NAII fully supports S. 2369.

In the interest of time, I will summarize my prepared statement which I understand will appear in the hearing record. I urge the members of the Finance Committee to read this brief statement in its entirety in order to understand why it is absolutely essential for any independent contractor legislation to provide a safe harbor classification for independent contractors. The stories of our companies detailing the unreasonable and unfair IRS audit and litigation activities in the employment tax area is shared throughout the property and casualty insurance industry. And certainly in any other industries that rely in part on independent contractors to compete in the marketplace.

A capsule of this is on pages 3 and 4 of my statement. And I would like to read it to the committee.

The Shelter Insurance Companies have since their inception conducted business through exclusive agents whom we and they consider to be independent contractors. Apparently, the Internal Revenue Service did too, for in repeated audits the issue of whether our commission agents were employees or independent contractors was never raised. That was from 1946 to 1972.

In November 1972, we learned the Internal Revenue Service was taking the formal position that our agents were employees. And assessments of allegedly unpaid taxes back through the year 1968 were made against us. The gross assessments for the years 1968 through 1974 was $19,148,563. In addition, while never formally levied against us, we were advised that 1975 and 1976 would add an additional $8,900,000 in allegedly unpaid taxes to be assessed against us.

Needless to say, we retained counsel and resisted these assessments. Our counsel pointed out repeatedly as they exhausted our administrative remedies that our agents were and are independent contractors and for the Internal Revenue Service to take the position that they were employees was contrary not only to the law and regulations the Internal Revenue Service itself had published, but also its stance in previous audits; to no avail.

At the time the Congress granted the remedy found in section 530 of the 1978 Revenue Act—the moratorium—our companies were in litigation in the court of claims. By this time, because of abatement of some assessments through the acquisition of 4669 forms, the $19 million assessment had been reduced to $10 million, which sum was made up of $7 million in taxes and $3 million in accumulated interest, which had to be placed in escrow. It should be noted that we were not permitted any abatement of assessments until March 1977. Consequently, for the years 1974, 1975, and 1976 our published financial statements carried the comments that we had a contingent tax liability. In our 1976 statements, the contingent liability amounted to this $19,148,000. As our surplus for protection of policyholders at that time was $57.2 million, we were, to say the least, apprehensive about our ability to continue as a viable organization.

This uncalled for change of position by the Internal Revenue Service and its unrelenting activity under different administrations and over an extensive period of time supports, without question, the absolute need for legislative protection to companies such as mine and to the industry. We are reluctant to rely on good faith where none has previously been demonstrated. And the tax collectors' actions were unbridled and unchecked until enactment of section 530 of the 1978 Revenue Act.

Legislation without a safe harbor will not solve the problems of the insurance industry. Nor, I am certain, of other industry groups. We are confident that under the common law, our agents are independent contractors. But to prove so will take lifelong costly litigation.

S. 2369 is a well-balanced bill put together through the efforts of Senator Dole, with the cooperation of Government and industry groups. Every provision is interlinked. We view the bill in its entirety and support it as such in fear that any substantive change might impair that support.

In conclusion, with this understanding, Mr. Chairman, the NAII supports without reservation S. 2369 and will actively support your efforts for its enactment into law.

On final comment. Last Monday, Internal Revenue Service examiners came to our office to examine us for the years 1978 through 1981. We would appreciate prompt action on this legislation so we will know at least once and for all where we stand with regard to this issue.

Thank you, Mr. Chairman.

[The prepared statement follows:]

SUMMARY

STATEMENT OF
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

April 26, 1982

The National Association of Independent Insurers recommends to the Subcommittee as follows:

1. That the Subcommittee maintain the historical treatment of commission insurance agents as independent contractors. (Statement pages 3-5.)
2. That the Subcommittee be mindful of the problems created by the Internal Revenue Service's change of position and how the Congress responded. (Statement pages 5-17.)
3. That the Subcommittee accept the Dole proposal, S. 2369, as the most sensible and workable solution to the employee-independent contractor classification problem. (Statement pages 17-25.)
4. That the Subcommittee reject any proposal for withholding on self-employed workers as being impracticable and not a solution to the problem posed. (Statement pages 14-16, 25-27.)

STATEMENT OF
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

April 26, 1982

This statement is submitted by the National Association of Independent Insurers (NAII) in support of S. 2369, the "Independent Contractor Tax Classification and Compliance Act of 1982," which was introduced on April 14, 1982 by Senator Dole to clarify the standards used for determining whether an individual worker is an independent contractor or an employee for federal employment tax purposes, and to improve tax compliance by independent contractors.

Background Concerning NAII

NAII is a voluntary, insurance company trade organization consisting of more than 500 members. Companies, both members and subscribers, now affiliated with the organization total more than 600. Members range from small companies doing business in only one state to one of the largest multi-state writers; from the highly specialized writer of farmers or other consumer groups to the so-called full multiple-line insurer; and from those merchandising their insurance products through the mails to those using various agency systems. Virtually every state is represented in the membership.

Structure of Agency Relationships in Casualty Insurance Industry

A large portion of the casualty insurance issued in the United States is written by companies which utilize an exclusive agency force. Many companies of this type were organized in order to provide low cost insurance protection in rural communities, and the use of an exclusive agency force was the only effective way to compete with older insurance companies which had established ties to existing general agents. The exclusive agency insurance companies include both mutual and stock companies.

Agents representing the companies are licensed by state insurance departments and must pass a written examination prior to obtaining a license. In general, the agents in question (including both full- and part-time agents) work from their own premises (either home or office), keep their own hours, solicit insurance business in their own ways, pay their own expenses, and are compensated by commissions. The agents are widely dispersed georgraphically, and most operate in areas in which the companies have no office or regular employees. District or regional sales managers are available to assist the agents if the agents so request, and, except in limited circumstances, the agents do not represent competing companies. The agency representation can generally be terminated by either party upon specified notice. Most of the companies have been carrying on business in essentially the same way for more than 40 years.

Historical Treatment of Commission Insurance Agents

For purposes of the employment tax provisions of the Internal Revenue Code--the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and Collection of Income Tax at Source on Wages (withholding)--the standard for determining whether a worker is an independent contractor or an employee has, with certain limited statutory exceptions, been the common law test of control. As formulated in the regulations, a worker is not treated as an employee unless the person for whom he performs services has the right "to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished." [Treas. Regs. §§ 31.3121(d)-1(c)(2) (FICA); 31.3306(i)-(1)(b) (FUTA); and 31.3401(c)-1(b) (withholding)].

Application of the common-law control test to commission insurance agents, such as those engaged in selling insurance on behalf of the casualty insurance industry, has traditionally resulted in such agents being classified as independent contractors rather than employees. The concurrence by the IRS in this classification is evidenced by the fact that over a period of 30 years commencing in 1937, seven published rulings were issued in which the IRS considered whether commission insurance agents are employees for employment tax purposes. The answer was uniformly in the negative: the IRS consistently ruled that commission insurance agents are not employees; they are independent contractors. G.C.M. 18705, 1937-2 Cum. Bull. 379; S.S.T. 249, 1938-1 Cum. Bull. 393; Rev. Rul. 54-309, 1954-2 Cum. Bull. 261; Rev. Rul. 54-312, 1954-2 Cum. Bull. 327; Rev. Rul. 59-103, 1959-1 Cum. Bull. 259; Rev. Rul. 69-287, 1969-1 Cum. Bull. 257; Rev. Rul. 69-288, 1969-1 Cum. Bull. 258. The courts likewise accepted this classification. Reserve National Insurance Co. v. United States, 74-1 U.S.T.C. ¶ 9486 (W.D. Okla. 1974); Standard Life & Accident Insurance Co. v. United States, 1975-1 U.S.T.C. ¶ 9352 (W.D. Okla. 1975); and Kelbern M. Simpson 64 T.C. 974 (1975). There are no contrary published rulings or judicial decisions.

Hence, for many years application of the common-law control test afforded insurance companies, commission insurance agents and the IRS a certainty that the relationship between insurance companies and commission insurance agents was that of independent contractors and not employees. All concerned relied on the fact that, with respect to such agents, insurance companies were not required either to withhold and remit income taxes and the employee share of FICA taxes or to pay FUTA taxes and the employer share of FICA taxes. On the contrary, since commission insurance agents were universally recognized to be independent contractors, they were considered by all to be directly responsible for paying their own income and self-employment taxes.

IRS Changes of Position and Congressional Response

However, commencing in approximately 1970 the IRS, disregarding its own long-established position, began to assert that commission insurance agents were employees. These assertions, which were made without the support of any published authority and without any announced change in position by the IRS, resulted in assessments being proposed or levied against insurance companies, including NAII's members, retroactively, on the ground that commission insurance agents should have been treated as employees for all open years. These assessments represented, in the main, duplication of federal income and self-employment taxes already paid by agents.

Concurrent with its about-face in the treatment of commission insurance agents, the IRS also began asserting for the first time that workers performing services in many other industries were employees rather than independent contractors as they had previously been considered. For example, John M. Samuels, Deputy Tax Legislative Counsel, Department of the Treasury, expressly acknowledged that the IRS had changed its position with respect to real estate agents by issuing new revenue rulings recharacterizing the relationship between real estate firms and real estate agents. In Mr. Samuels' words: "They [the new revenue rulings] represented what could fairly be characterized as a change in position with respect to real estate salespeople." (Hearings before Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 2d Sess. at p. 121). Similarly, in the case of Aparacor, Inc. v. United States, 556 F.2d 1004 (1977), the United States Court of Claims stated that the Service's attempt to reclassify as employees many thousands of individuals engaged in selling products at retail on a commission basis represented "a radical departure from the traditional common-law concept of an employer-employee relationship."

As a result of these IRS changes in position, confusion suddenly reigned where certainty had been the rule. Congress soon became cognizant of the problem and, during the deliberations on the Tax Reform Act of 1976, endorsed a statement in the Conference Report urging the IRS not to retroactively apply any changed position in the employment tax area pending completion of a study by the staff of the Joint Committee on Taxation. (Conf. Rep. on H.R 10612, p. 489).

When it become clear that the IRS was not honoring the Congressional request,* Congress responded by enacting section 530 of the Revenue Act of 1978, which was designed to provide interim relief for taxpayers while Congress develops a comprehensive, permanent solution to these controversies. In general, section 530 terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. Several "safe havens" were established which, if satisfied, entitle taxpayers to relief. In addition, section 530 allows such taxpayers to continue to treat workers as other than employees through 1979.

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*The IRS cavalier disregard of the Conference Report is illustrated by the Treasury Department's response to a request from Senator Curtis that the Subcommittee on Taxation and Debt Management Generally be provided with "all directions, bulletins, letters, communications, regulations, and so on" that were sent out to all IRS offices and employees instructing them to follow the language of the Conference Report. The Treasury Department indicated that the Congressional request was essentially meaningless and that, accordingly, no such communications had been sent out:

> The conferees on the Tax Reform Act of 1976 urged the Internal Revenue Service not to apply to past tax years any changed position or any newly stated position which is inconsistent with a prior general audit position in this area. The term "general audit position" has little or no meaning. Determinations as to whether workers are employees or independent contractors are made by applying the longstanding common law rules on a case-by-case basis, in accordance with the regulations and revenue rulings which were in effect before the Conference Report was issued. However, to the extent that it is possible to identify a "general audit position"--and hence to depart from such a position--such departures are initiated only by the National Office of the Internal Revenue Service. Therefore, it was not necessary for the National Office to instruct field offices not to make such departures. (Hearings before Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 2d Sess. at p. 220)

While the relief provided by section 530 did much to assuage the concerns resulting from the uncertainty caused by the IRS changes in position, the solution provided by that section is, by design, only an interim one; the relief extends only through June 30, 1982. Therefore, immediate action must be taken by Congress.

Senator Dole has cogently stated the need for a prompt Congressional solution:

> Since the early 1970's the Internal Revenue Service. . . . has tried to recharacterize as employees many individuals who were traditionally considered independent contractors. This increase in audits, and retroactive tax assessments, has imposed a great burden on many businesses that relied upon longstanding characterization of certain workers as independent contractors. Much of the problem with the IRS reclassification campaign stemmed from the absence of clear statutory rules defining the difference between an employee and an independent contractor for tax purposes.
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> Since 1978, Congress has provided a temporary solution to the reclassification problem by allowing businesses to continue to

> treat workers as independent contractors if there was a "reasonable basis" for treating them as independent contractors in the past. When I sponsored the first such measure, the intention was simply to preserve the status quo until Congress had an opportunity to fashion a permanent solution. When the first temporary measure expired at the end of 1980, this Senator was reluctantly forced to offer an additional 18-month extension of the status quo. The present moratorium expires on June 30, 1982. It is plainly time for Congress to provide a permanent solution to the classification problem, together with improved compliance measures for the independent contractor sector.

If action is not taken promptly to provide a permanent solution, the uncertainty and chaos which existed in the years prior to the enactment of section 530 will likely return.

Reasons for NAII Members' Concerns--Problems Created By Change of Agents' Employment Tax Status

The problems which will be faced by commission insurance agents, by insurance companies, and by individuals and companies in other affected industries, as a result of uncertainties as to employment tax status are of enormous proportions. These problems include the following:

1. Social and Economic Impact. Commission insurance agents have traditionally and historically viewed themselves, and have been viewed by others, as independent businessmen whose success is attributable to their individual initiative and independent

operations. As such, they rightfully take pride in their status as independent entrepreneurs. If Congressional action is not taken to reaffirm that these individuals are indeed independent contractors, long-established social and economic relationships will be threatened, with reverberations reaching far beyond the employment tax area.

2. HR-10 Plans. A large number of commission insurance agents have adopted self-employed persons' pension or profit-sharing plans (HR-10 plans), many of which have been approved by the IRS. If the IRS should again be free to assert that these agents are employees rather than independent contractors, the status of these numerous plans would be placed in doubt. The specter would exist of having these plans retroactively disqualified, since the individuals who adopted them might be deemed to be employees and therefore not entitled to maintain HR-10 plans. The result could well be a review of numerous income tax returns of commission insurance agents. If the agents have previously received determinations from the IRS that they are independent contractors and are then reclassified as employees, the plans would be frozen and any future contributions would not be exempt from tax. If the agents had not previously received such

determinations, the plans would be disqualified, and all amounts in the plans (previous contributions plus income) would be taxable. The potential adverse consequences of such a disqualification would be substantially increased for any commission insurance agent who might choose to take advantage of the increased contribution levels approved last year as part of the Economic Recovery Act of 1981.

3. Effect on State Income Tax Liability. The federal employment tax classification of workers as employees or independent contractors is paralleled by many state income tax statutes. The rules for withholding of state income taxes generally coincide with federal withholding rules. Moreover, the applicability of certain exclusions and deductions may depend on a worker's employment status (as is the case with respect to some exclusions and deductions under federal law). Thus, for example, in order to claim business expenses as "above the line" deductions from gross income in determining federal income tax liability, a worker must usually be self-employed. The same rules usually prevail in State systems as well, and the status classification systems are ordinarily the same. Obviously, if the employment tax status of these workers is not clarified by Congress

and is subsequently challenged by the IRS, they could face substantial state tax deficiencies.

4. Status of Employees of Agents. Many commission insurance agents have their own employees. Absent Congressional clarification of the standards for differentiating between employees and independent contractors, serious questions will exist as to the status of employees of such agents. The insurance companies have no control over the hiring, firing, compensation, or supervision of agents' employees, who may suddenly be treated as employees of the companies.

5. Company Pension and Profit-Sharing Plans. Qualified pension and profit-sharing plans maintained by insurance companies have not provided for the coverage of agents--in accordance with published pension trust section rulings which flatly state that commission insurance salesmen cannot be covered under a qualified plan. If the employment tax status of commission insurance agents should again be subjected to challenge, these qualified plans may be disqualified for failure to cover the agents in question. This could result in the disallowance of contributions, taxing the income of the plans, and direct injury to thousands of employees who are

beneficiaries of the plans. A Report issued by the General Accounting Office documented that such a result is not purely theoretical. The Report disclosed that in one instance a company had established a generous retirement plan for its office employees. After the IRS determined that the company's independent contractors should have been classified as employees, the company was forced to terminate the office employee's pension plan because it could not afford to extend the plan to the individuals who had been reclassified as employees. The result was that the reclassified individuals lost their eligibility to establish HR-10 plans and the office employees lost their retirement benefits. ["Report to the Joint Committee on Taxation, Congress of the United States, by the Comptroller General of the United States--Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," pp. 15-16 (November 21, 1977) (hereinafter referred to as the "1977 GAO Report")].

6. Penalizing Effect of Changes in Status. Should the IRS again be free to throw down the gauntlet on this issue, insurance companies would be faced with substantial burdens in the operations of

their businesses even if they should ultimately prevail in establishing that their commission agents are independent contracts. Such challenges would give rise to contingent liabilities which ordinarily must be noted for financial statement purposes, with the result that the ability to raise capital, borrow money, take advantage of business opportunities, and even to sell insurance might be impaired. Additionally, the companies might be subjected to tax liens for the unpaid, disputed tax liabilities, or to the substantial costs of posting bonds or collateral.

7. Impracticability of Withholding. If the IRS is permitted to resume its attempts to change the classification of commission insurance agents from independent contractors to employees, significant problems concerning withholding of income taxes and the "employee's" share of FICA taxes, as well as the company's liability for the "employer's" share of FICA taxes, would result. Commissions paid to insurance agents constitute gross income. From these the agents must deduct business expenses, which could include such things as wages of the commission agent's employees, office expenses, and automobile expenses. The insurance company has no way of determining the amount of these expenses. Obviously, such gross

commissions cannot be equated with "wages" in any fair interpretation of the term.

NAII understands that this problem is exacerbated in other industries where the individuals whose employment tax status is in question purchase goods from their putative "employer" company at a wholesale price and sell them at retail. In these instances, not only does the company not know the amount of the individual's income after deduction of business expenses, but it also often does not know the amount of the individual's gross income. Moreover, because no payments are made by the company to the individual, there is nothing from which to withhold employment taxes.

Withholding on gross compensation, whether in the form of commissions to insurance agents or in some other form, can also have a significant adverse impact on the individual workers, since they could well face problems of overwithholding of income tax. Even if such individuals were extended the right to claim additional personal exemptions on their employee withholding statements to reduce the amount withheld from their gross income, it might be difficult, if not impossible, to estimate the amount of future commissions and expenses, and thus the number of exemptions to claim.

8. Effects of Competitive Relationships. Absent Congressional clarification of the standards for determining the employment tax status of workers, companies subjected to IRS challenge as to the employment tax status of their commission insurance agents may be placed at a competitive disadvantage with respect to other insurance companies. The example posited by the Staff of the Joint Committee on Taxation is illustrative:

> [A]ssume that the A company and the B company are substantially similar enterprises, and that A's workers are treated as independent contractors, while B's workers (who perform functions identical to those of A's workers) are treated as employees. (This difference in treatment could be explained either in terms of each business' interpretation of the common law test, or by virtue of a reclassification of workers by the Service pursuant to an audit.) In such an instance, the B company must withhold income taxes from its worker's compensation, and pay an employer's share of employment taxes. Moreover, B must comply with the various obligations pertaining to recording and depositing such funds, in addition to furnishing each employee with an annual statement as to that employee's taxes. On the other hand, the A company simply must record the amounts paid to its workers in such a manner that A can substantiate the payments for tax purposes generally, and determine whether the aggregate annual payments to any worker necessitates the filing of information

> returns. While A's failure to satisfy the latter obligation could result in a $1 penalty per covered payment, B's failure to comply with its obligations could result in substantial penalties. Thus, because of the significantly different obligations of each company, A might have a competitive advantage over B. ["Issues in the Classification of Individuals as Employees or Independent Contracts: A Report Prepared by the Staff of the Joint Committee on Taxation," p. 21 (February 28, 1979)].

Notably, even if a withholding proposal were to be enacted into law, the question of employment tax status would still remain unanswered. Accordingly, the risks of companies being subjected to competitive disadvantages as a result of IRS challenges to the status of commission agents would remain.

S. 2369 Provides a Sensible, Workable Solution

If problems such as these are to be avoided, Congress must take immediate action to provide definitive standards for determining the employment status of workers in industries, such as the insurance industry, where the IRS created havoc by reclassifying as employees workers who have long been recognized by all to be independent contractors. We believe that S. 2369 will accomplish this end by providing standards which will preserve the status of workers who have historically been recognized to be independent contractors.

The safe-harbor approach of the Bill recognizes, as did the 1977 GAO Report, that it is not feasible to impose a rule that will clearly establish the status of all workers. Any bill attempting to do that would likely produce arbitrary results which would impose unnecessary hardships on both workers and those for whom services are performed. The harm caused by such an approach could be as bad as that caused by the Service's past changes in position. No such broad-brush approach is necessary.

What is necessary is to restore to workers and companies in the industries affected by the IRS reclassification program the certainty as to employment status which has long existed and upon which those individuals and companies have relied in establishing their relationships and planning their affairs.

S. 2369 will accomplish this result. The five-factor test which it adopts as a precondition to coming within the "safe harbor" will restore to this confused area of the tax law the certainty which is so vital. It will permit both individual workers and companies in the affected industries to know with a high degree of assurance both the nature of their relationships and their respective employment tax responsibilities. At the same time, the Government will be provided the information necessary to insure compliance with the tax law.

Thus, for example, under the provisions of this Bill commission insurance agents and the companies for which they sell insurance will have restored to them the certainty that theirs is an independent contractor relationship. They will be able to meet the Bill's tests which go to the substance of the relationship without making changes in the way they have traditionally structured their relationships and conducted their businesses.

- Control of hours. Commission insurance agents have historically controlled both the number of hours they spend selling insurance and the scheduling of those hours.

- Place of business. The majority of commission insurance agents operate out of their own homes or offices. They do not conduct their business in offices provided by insurance companies.

- Income fluctuation or investment. By the very nature of being remunerated on a commission basis, commission insurance agents have no assurance that their income will bear any relation to the amount of time devoted to selling insurance. Rather, commission insurance agents assume the risk of fluctuations in income based on their own degrees of success in selling insurance. Moreover, insurance agents who receive override commissions based on the sales of others with whom they work jointly or whose activities they oversee likewise have no assurance that their income will bear any relation to the amount of time they spend in their endeavors; they bear the risk of significant income fluctuation.

Since many commission insurance agents maintain offices, they would also meet the alternative test of the bill--substantial investment in assets.

These tests would take effect on June 30, 1982 or on the date the Bill is enacted, whichever is earlier. By virtue of complying with these tests, which go to the substance of the relationship, commission insurance agents and insurance companies will again be able to operate with the assurance that their relationship is, as it has always been, not one of employment, but of independent contractors. In short, the Bill will codify what has always been understood. At the same time, the tests set forth in the Bill should not allow parties artificially to assume the posture of independent contractors, since each of the tests is by its very nature inconsistent with an employer-employee relationship. One who sets his own hours of work, maintains his own place of business, and whose income is not directly tied to the amount of time spent working or who has a substantial investment in the assets of the business is not an employee. And one who is an employee will not be able to meet these tests. Accordingly, the Bill will not allow individuals and companies which have traditionally operated in an employment relationship to escape their employment tax responsibilities.

In addition, beginning in 1983, the Bill requires that the worker must perform services pursuant to a written contract which informs the worker of his independent contractor status. The worker must also be informed either in the contract or at the time it is executed of the tax obligations imposed on him as an independent contractor. The Bill thereby ensures that those who seek to come within its safe harbors will know what their status is and what their resulting tax responsibilities are.

Penalties and reporting requirements. As Senator Dole has stated, the Bill provides "a new penalty system designed to put teeth in the information reporting requirements for the first time." With respect to payment for services over $600 after 1982, the Bill requires that the person for whom services are performed must file information returns with the Government. In addition, independent contractors must be given a statement similar to Form 1099. For failures to file such returns or provide such statements, the Bill imposes a penalty equal to 1% per month of the payments not reported, up to a maximum of 5%. The penalty is doubled and tripled for numerous failures. The minimum penalty is $50 for each failure to file an information return or to provide a statement to independent contractors.

Significantly, the Bill provides that no penalties are imposed if the failure to file a return or provide a statement is due to reasonable cause and not willful neglect. This provision is particularly important since the penalties in the Bill are not limited to situations in which the parties are relying on the safe-harbor provisions to establish the existence of an independent contractor relationship. The reporting requirements are sometimes unclear with respect to people who render services and who might be considered independent contractors under the common law. Thus, without a reasonable cause provision in the Bill, insurance companies could be assessed a penalty for failing to furnish statements in situations where they reasonably believed no statements were required. For example, in Rev. Rul. 81-232, I.R.B. 1981-40, 10, the Internal Revenue Service ruled that an insurance company which paid an unincorporated shop to repair an insured automobile was required to include in the Form 1099 not only the amounts paid for labor and services, but also the amounts paid for parts. The IRS reasoned that the obligation to furnish parts was incidental to the obligation to repair the car. Prior to this ruling, the reporting obligation of insurance companies in this situation had been unclear. The Bill's provision that penalties will not be applied where the failure to file or furnish statements is due to reasonable cause and not willful neglect should protect taxpayers who find themselves in situations where it is unclear whether an obligation to file a report exists.

The Bill also provides that an independent contractor must furnish his correct Social Security or identification number to the person for whom he performs services. This provision will allow the Government to detect unreported payments by matching information returns against the income tax returns filed by the independent contractors. The Bill requires the person for whom services are performed to withhold taxes at 15% if the independent contractor fails to furnish his identification number or furnishes an incorrect number.

The Bill imposes similar reporting requirements and penalties for direct sales of certain consumer goods in the home after December 31, 1983.

The Bill creates a workable and equitable reporting system under which each taxpayer will bear his fair share of the tax burden. As Senator Dole has stated, the "penalty system should give businesses a substantial incentive to properly comply with the information reporting rules already on the books. This system should also discourage intentional nonfiling of information returns and intentional filing of incomplete returns." The reporting requirements and penalties in the Bill ensure that the Government will have the appropriate tools to enforce compliance with the tax laws.

Accordingly, the Bill completely answers the concerns expressed by the Department of the Treasury and the Internal Revenue Service in a joint letter appended to the 1977 GAO Report. Those concerns were that a change in the law might increase the number of self-employed persons, that self-employed individuals allegedly have a low compliance rate in reporting income earned, and that consequently such a change might result in lost tax revenue. NAII seriously doubts the validity of these concerns, at least with respect to the casualty insurance industry, since studies have shown an extremely high level of compliance by insurance agents associated with member companies of NAII. Indeed, even a limited compliance study conducted by the Internal Revenue Service shows that 98.3 percent of compensation received by casualty insurance agents is reported. (See Statement of Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy) before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, Table 9, June 20, 1979). Furthermore, as Senator Dole has stated, the Bill "does not permit any workers now classified as employees under the common law to switch their status to that of an independent contractor without substantial changes in the nature of their relationship with their employer."

Thus, it is readily apparent that the matters over which Treasury and the Internal Revenue Service have expressed concern will not come about under S. 2369, since the tests which have been incorporated into the Bill cannot be met by an individual who is properly classified as an employee, and since the penalties and reporting requirements in the Bill will enable the Internal Revenue Service to enforce compliance with the tax laws.

Withholding on Payments to Independent Contractors Would Provide No Solution

Faced with taxpayer and Congressional concern caused by the countless problems resulting from prior distorted applications of the common law control test, the previous Administration sought to sidestep the issue by proposing an expanded form of withholding which would be applicable to payments made to independent contractors. No similar proposal for withholding on payments to independent contractors has been made by the present Administration. However H.R. 5867 introduced March 17, 1982, again raises the spector of withholding as the solution.

Any such proposal would be inherently deficient. It would leave totally unanswered the basic issue which has given rise to the entire problem -- finding workable standards for determining whether, for Federal employment tax purposes, an individual worker is an independent contractor or an employee.

Any "solution" which fails to resolve this basic issue would be no solution at all. Payors and individual workers would remain in the quagmire which existed in the common law prior to the enactment of section 530 of the Revenue Act of 1978. In view of the IRS' recognized history of "radical departures from the traditional common-law concept of an employer-employee relationship," how would payors know with certainty whether they had a liability for FUTA tax with respect to individual workers? How would payors determine with certainty whether they had a liability for the employer's shares of FICA taxes? Merely extending withholding to encompass payments to independent contractors offers no solution to these questions. Moreover, individual workers would be left in the same quandary. They would have no sound basis for determining whether their remuneration is subject to withholding or to self-employment taxes. Similarly, their HR-10 plans, and the pension and profit-sharing plans set by companies for which they perform services would remain subject to disqualification should the IRS determine under its distorted reading of the common-law control test, that those individual workers are employees and not independent contractors.

In short, expanding withholding to cover payments to independent contractors would do nothing to end the problems of uncertainty about the definitions of "employee" and "independent contractor." Both payors and individual workers would be left with no clear standards to assure them that they are acting within the law. The United States Supreme Court has expressly held that especially in this area of the tax law, where employers are required to act as collection agents for the government, the "obligation to withhold [must] be precise and not speculative." Central Illinois Public Service Co. v. United States, 98 S.Ct. 917 (1978). Any solution which sought to impose withholding on payments to independent contractors would fall far short of this admonition.

Conclusion

NAII believes that S. 2369 will protect the interests of all concerned. Those whose longstanding status as independent contractors has recently been challenged by the Service's reclassifications program will receive the necessary reaffirmation that their independent contractor relationships will not be changed. Those who are not entitled to independent contractor status will not be able to utilize the provisions of this Bill to assume that status. And the Government has been given the tools and information necessary to ensure that those who seek the safe harbors of the Bill are complying with their obligations under pertinent provisions of the tax laws.

NAII believes this Bill provides the comprehensive solution which the Congress indicated it was seeking when it enacted the interim relief provision in the Revenue Act of 1978, and we urge the Subcommittee to recommend its enactment.

NAII is aware that sufficient time may not remain to permit the Congress to enact such a bill which will once and for all resolve the problems in this area prior to June 30 of this year. Therefore, if the Congress should again conclude that a prospective solution to this most difficult problem cannot be timely enacted, NAII urges that the relief provisions of section 530 of the Revenue Act of 1978 be extended until a definitive solution is forthcoming.

Senator DOLE. Mr. Roberts.

STATEMENT OF DAVID D. ROBERTS, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, D.C.

Mr. ROBERTS. Mr. Chairman, my name is David D. Roberts. I am a realtor from Mobile, Ala., and presently a member of the executive committee of the National Association of Realtors. We welcome and appreciate this opportunity to present our views on S. 2369, which would provide legislative standards to help determine whether individuals are employees or independent contractors for Federal tax purposes.

We urge the committee to favorably report this bill. And we commend you, Chairman Dole, for your initiative in introducing this legislation.

For the past 40 years, Mr. Chairman, the central controversy in the employment tax area has been the status of certain individuals as employees or independent contractors. I am the president of my own real estate company in Mobile. We employ about 25 people. For those employees, we fully comply with all the local, State, and Federal regulations and reporting requirements that are applicable. And there are a great many, as you well know.

In addition to these employees, my company has under contract 150 other persons who are independent contractor real estate salesmen and saleswomen who are diligently meeting their tax obligations.

We thank the members of the committee and the Congress in general for providing the needed interim relief from unjustified IRS attempts to reclassify these salespeople as employees. This important relief originally provided by section 530 of the Revenue Act of 1978 will expire at the end of June. That is why it is so important to focus now on long-term legislation.

The National Association of Realtors supports S. 2369 for providing reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or independent contractor. The bill provides a safe harbor by giving certainty as to tax status to independent contractors who are able to meet the five strict requirements contained in the bill.

At the same time, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five safe harbor provisions. This safe harbor approach is important because it would be virtually impossible to design one specific legislative proposal to clearly meet the standards for all the occupations and industries affected by this issue. S. 2369 would provide a measure of certainty in those industries where the IRS reclassification program has disrupted business relationships and threatened the very existence of the independent small business person.

In addition to the safe harbor classification standards, the bill would also impose penalties for failure to file information returns with respect to remuneration paid to independent contractors. S. 2369 would not create, with one limited exception, any new information reporting or recordkeeping requirements. Rather, it would impose stricter penalties for failing to comply with existing compliance provisions. The National Association of Realtors supports the compliance provisions in S. 2369.

Improved information reporting on payments to independent contractors would help assure voluntary tax compliance throughout the independent contractor sector of the economy. We are pleased to note that some of our recommendations to increase compliance—a higher dollar penalty for the failure to file Form 1099 and requiring independent contractors to be given a copy of Form 1099 by the service recipient—have already been enacted as part of last year's tax bill. The compliance provisions in S. 2369 would complete the job of insuring that everyone pays his or her fair share of tax.

Mr. Chairman, S. 2369 would go a long way toward providing business taxpayers with greater certainty in classifying workers for tax purposes while assuring tax compliance. We urge you to have your committee report this bill favorably.

I would be pleased to respond to any questions from the Chair.

[The prepared statement follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
TAX TREATMENT OF INDEPENDENT CONTRACTORS
to the
SENATE FINANCE SUBCOMMITTEE ON
OVERSIGHT OF THE INTERNAL REVENUE SERVICE
by
DAVID D. ROBERTS
April 26, 1982

My name is David D. Roberts. I am a REALTOR® from Mobile, Alabama, and presently a member of the Executive Committee of the NATIONAL ASSOCIATION OF REALTORS®.

BACKGROUND

For over 40 years, the central controversy in the employment area has been the question of whether particular workers or classes of workers should be treated as employees or as self-employed independent contractors. The distinction is important under existing law because employees and their employers are subject to tax under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) (Sections 3101 and 3301 of the Internal Revenue Code), whereas independent contractors are subject to tax on self-employment income (SECA) imposed by Section 1401 of the Code. Also, compensation paid to employees is subject to income tax withholding under Section 3402 of the Code, whereas independent contractors make quarterly income tax payments on their own behalf. Further, self-employed persons can establish Keogh retirement plans, whereas employees may not (although they may be able to establish Individual Retirement Accounts). Thus, reclassification of an independent contractor as an employee can cause a retirement plan to become taxable in the current year.

It is also important to note that income and Social Security taxes are withheld from an employee based on his gross compensation, whereas an independent contractor pays these taxes based on his net earnings after expenses. The distinction is very important to many independent contractors, such as real estate salespeople, who incur significant expenses in the pursuit of their livelihood. Reclassifying real estate salespeople as employees and thereby basing these taxes on gross earnings causes problems regarding overwithholding of income taxes. The problem of overwithholding of income taxes arises, for example, in the case of a real estate salesperson with significant but fluctuating business expenses. While a taxpayer may claim additional personal exemptions on his employee withholding statement to reduce the amount withheld from his gross income, it may be difficult, if not impossible, for a real estate salesperson to estimate the amount of his future business expenses and, thus, the proper number of additional exemptions to claim.

One of the major reasons for the attempt by the Internal Revenue Service to reclassify independent contractors as employees was to make its own administrative functions easier. Yet, the IRS was trying to make sweeping substantive changes in the law to ease these administrative duties. A reclassification of independent contractors as employees would produce little if any additional revenue. Revenue is not greatly increased because an independent contractor pays, on his own behalf, income and Social Security taxes corresponding to those withheld and paid by an employer on behalf of his employees. (There may be some increase because of the difference between FICA and SECA taxes). Revenue may, in fact, be decreased because reclassification as an employee may cost the marginal worker his livelihood due to increased tax, administrative, and bookkeeping costs to the alleged employer.

The Treasury Department claimed in 1979, based on an Internal Revenue Service compliance study of dubious validity, that the present lack of withholding of income taxes on payments to independent contractors causes underreporting of income on tax returns. Yet, according to the IRS's own data, at least 96% of the compensation received by independent contractors in the real estate industry is reported on tax returns. This is higher than the average level of compliance found in the American economy. Further, the General Accounting Office (GAO), in its report to the Joint Committee on Taxation regarding the tax treatment of employees and self-employed persons (dated November 21, 1977), stated that "those taxpayers involved in employee self-employed redeterminations had generally paid their income and Social Security taxes." Moreover, GAO pointed out that the IRS failed to consider other possible administrative approaches to the problem of underreporting.

Nevertheless, in order to prevent the alleged underreporting of income by independent contractors, the Treasury Department proposed the initiation of a burdensome and ill-considered withholding scheme under which all real estate brokers would be required to withhold tax on commissions paid to independent contractors. At the same time, however, the Treasury Department proposed nothing to provide necessary and desirable clarification to the tax status of independent contractors in the real estate industry. Clarification of tax status has become necessary only over the last few years, and only because of the misapplication of the long established common law test by the IRS.

The history of the tax treatment of real estate salespeople as employees or independent contractors under the common law test goes back many years. In 1938, the IRS issued a Social Security Tax ruling, S.S.T. 346, 1938-2 C.B. 300, which concluded that a typical real estate broker did not retain sufficient right to control the salespeople to establish the relationship of employer and employee. Five years later, the IRS concluded that S.S.T. 346 was erroneous and published Mimeograph 5504, 1943 C.B. 1066, holding that real estate salespeople in general should be treated as employees rather than independent contractors.

The courts, however, refused to accept the new position of the Service that real estate salespeople should be treated as employees rather than independent contractors. The courts held, first in Broderick v. Squire, 163 F. 2d 980 (9th Cir. 1947), and then in the leading case of Dimmitt-Rickhoff-Bayer Real Estate Co. v. Finnegan, 179 F. 2d 882 (8th Cir. 1950), that real estate salespeople should be treated as independent contractors under the authority of the decision of the U.S. Supreme Court in Harrison v. Grey Van Lines, 331 U.S. 704 (1947). The result in Dimmitt was accepted by the Service in Mimeograph 6566, 1951-1 C.B. 108, which revoked Mimeograph 5504 and stated that real estate salespeople would not be treated as employees where the facts are substantially similar to those of Mimeograph 5504 or the Dimmitt case.

For a quarter of a century after the publication of Mimeograph 6566 in 1951, it remained in effect as the official position of the IRS. Then, as a result of the misapplication of the common law test of control and for reasons of administrative convenience, the IRS suddenly reversed this position and took the view that real estate salespeople are employees and not independent contractors. Revenue Ruling 76-136, 1976-1 C.B. 312, and Revenue Ruling 76-137, 1976-1 C.B. 313. These Revenue Rulings were subsequently revoked by Revenue Ruling 78-365, 1978-2 C.B. 254, as a result of Congressional interest in connection with the Revenue Act of 1978.

The IRS misapplied the common law test of control because it apparently adopted the view that the existence of one "controlling factor" in a business relationship requires a worker to be classified as an employee, contrary to the established rule that no single factor is controlling on the classification question. See Treasury Regulation Section 31.3121(d)-1(c).

The Treasury Department, through the IRS, took this approach because it apparently believed that it is more convenient to collect taxes under a withholding scheme than to perform its true function of enforcing the laws enacted by Congress. In order to impose this withholding burden, it was necessary to reclassify real estate salespeople as employees rather than independent contractors.

As a result of this action, the common law test of control, which has served us well over the course of many years, has been distorted and misapplied by a Federal regulatory agency for purposes of its own administrative convenience. The NATIONAL ASSOCIATION OF REALTORS® urges this Committee to give serious consideration to the enactment of reasonable legislative standards under which real estate salespeople and other independent contractors can be certain as to their status for employment tax purposes. The standards proposed in the Independent Contractor Tax Classification and Compliance Act of 1982, S. 2369, discussed below, are reasonable and will give certainty to brokers and to real estate salespeople as to their tax status.

THE INDEPENDENT CONTRACTOR TAX CLARIFICATION AND COMPLIANCE ACT OF 1982

The Independent Contractor Tax Status Clarification Act of 1982, S. 2369, introduced by Senator Bob Dole and cosponsored by a number of other Senators, would provide a set of five requirements that, if satisfied, would result in a worker being treated as an independent contractor. All five of the requirements must be met before a worker will be treated as an independent contractor under the Act. If the worker is not able to satisfy all five requirements, his status will be determined under the common law test.

The five requirements listed in the Act for "safe harbor" treatment as an independent contractor are the following:

(1) The worker must control the aggregate number of hours actually worked and substantially all the scheduling of the hours worked.

(2) No principal place of business (if any) of the worker with respect to the service is provided by the service-recipient unless the worker pays such service-recipient a fair rental. For purposes of this test, no place of business provided an individual by a service-recipient shall be treated as a principal place of business with respect to the services if substantially all of the service is not performed at such place or any other place

of business provided by the service-recipient.

(3) The worker has a substantial investment of his services or risks income fluctuations with respect to his services

(4) The services of the independent contractor must be performed pursuant to a written contract that spells out the individual's status as an independent contractor and the consequences and responsibilities of such status, and the person or company for whom the worker performs the services must file all required information returns (such as Form 1099).

Mr. Chairman, a reasonable interpretation of S. 2369 would give taxpayers certainty in this area while at the same time addressing the concerns of the Treasury Department and the Internal Revenue Service.

Control of Hours Worked

The Act would require that the worker control his working hours in order to qualify for the "safe harbor." This test will be satisfied only if the worker has the right to control the total number of hours worked. Control of working hours is one of the critical factors in the common law test for classifying workers as either employees or independent contractors.

We should emphasize that the fact that an independent contractor performs services for only one person or company during the year has no bearing on this test. For example, real estate salespeople under state law in all 50 states may perform services for two or more brokers. This requirement does not affect the control of hours, and real estate salespeople could meet the test as long as they had the right to control the aggregate number of hours worked and substantially all of the scheduling of these hours.

Place of Business

This requirement of the Act takes into account the fact that, under the common law test, an independent contractor provides his own principal place of business or may have no one principal place of business. This requirement in the Act also takes into account, however, the realities of doing business in a modern society. Thus, the Act would allow the person for whom services are performed to provide the independent contractor with his principal place of business, but only if the worker pays rent therefor. This rent should be either a reasonable fixed amount paid by the independent contractor or a mutually agreed upon division of fees or commissions.

The place of business test in the Act also recognizes that many individuals, real estate salespeople among them, simply should not be treated as having a principal place of business. Real estate salespeople do not perform their services at a single fixed location even though the brokers for whom they perform these services often provide desks for their use. Since real estate salespeople move from home to home and customer to customer, the Act would correctly treat them as having no principal place of business for purposes of this test.

Investment or Income Fluctuation

The Act would codify the common law provision that an independent contractor's income level is not fixed or guaranteed. A real estate salesperson may make sales presentations over a period of time and incur significant expenses and yet, if no sale was made, he would derive no income for his efforts. In fact, he would incur a loss.

It is the risk of income fluctuation that is the crux of this test. Actual income fluctuation may arise from a variety of factors having to do with the salesperson's skill and degree of effort. However, as long as the salesperson exposes himself to the risk that, despite all his efforts, he may generate no sales and therefore no income, this test would be satisfied.

This test may also be satisfied if the worker has a substantial investment in the assets used in connection with the services performed.

Written Contract and Filing of Required Returns

The final "safe harbor" provision in the Act would require the worker and the person for whom the services are to be performed to enter into a written contract, prior to the performance of the services, clearly indicating that the worker is an independent contractor and his tax responsibilities as a result of that status. Further, all information returns must be filed by the person for whom services are performed.

This requirement is intended to ensure that workers are aware of the tax responsibilities arising from independent contractor status and are provided with all the information necessary to meet these responsibilities. This requirement also ensures that the IRS has all the information necessary to monitor the tax collection process.

Compliance

In addition to the safe harbor classification standards, the bill would also impose penalties for failure to file information returns with respect to remuneration paid to independent contractors. S. 2369 would not create, with one limited exception, any new information-reporting or record-keeping requirements. Rather, it would impose stricter penalties for failing to comply with existing compliance provisions.

The NATIONAL ASSOCIATION OF REALTORS® supports the compliance provisions in S. 2369. Improved information reporting on payments to independent contractors would help assure voluntary tax compliance throughout the independent contractor sector of the economy. We are pleased to note that some of our recommendations to increase compliance, a higher dollar penalty for the failure to file Forms 1099, and requiring independent contractors to be given a copy of a Form 1099 by the service-recipient, have already been enacted as part of last year's tax bill. The compliance provisions in S. 2369 would complete the job of ensuring that everyone pays his or her fair share of tax.

COMMENTS ON S. 2369

The five safe harbor classification standards set forth in the Act are very strict. The NATIONAL ASSOCIATION OF REALTORS® believes that the standards should be strict in order to prevent workers who should obviously be classified as employees from inadvertently being reclassified as independent contractors.

S. 2369 was not designed or intended to "reclassify" anyone as an independent contractor and we do not believe that any workers who are presently considered employees would become independent contractors under the Act. The Act was, however, designed and intended to establish rules and provide certainty in those industries where the IRS's reclassification program has disrupted business relationships and threatened the very existence of the independent businessperson. The only individuals who may be reclassified as independent contractors under the Act are those individuals who, as a result of the coercion and heavy-handedness of past IRS reclassification efforts, were forced into employee status and are returning to their rightful place among the ranks of independent contractors.

There can also be no argument that, solely as a result of this Act, individuals would suddenly deem it essential to refer to themselves as independent contractors. S. 2369 does nothing more than codify the long-established independent contractor standards of the common law. Since we have not experienced massive switch-overs under these long-established standards over a course of so many years, we do not believe we will have massive switchovers as a result of this Act. In fact, given the strictness of the five requirements listed in the Act, massive switchovers are simply not possible.

CONCLUSION

The NATIONAL ASSOCIATION OF REALTORS® urges this Committee to favorably report S. 2369. This bill would provide a measure of certainty in determining the classification of a worker as an employee or independent contractor. S. 2369 would provide this certainty while at the same time maintaining the freedom to enter into a business relationship as an employee or independent contractor.

We appreciate this opportunity to present our views on this matter of urgent concern. We will be happy to try to answer any questions the Committee may have. Thank you.

Senator GRASSLEY. Mr. Barber, you are next.

STATEMENT OF MONTY BARBER, VICE CHAIRMAN OF THE BOARD OF DIRECTORS, THE DIRECT SELLING ASSOCIATION, WASHINGTON, D.C.

Mr. BARBER. Mr. Chairman, and members of the subcommittee, my name is Monty Barber. I'm vice chairman of the board of directors of the Direct Selling Association, which I will refer to in my testimony as DSA. And I am also vice president and general counsel of Mary Kay Cosmetics, Inc.

With me today are Neil Offen, president of DSA; John Beyer, president of Robert R. Nathan Associates; and Arthur Rothkopf from the Washington law firm of Hogan & Hartson, who serve as tax counsel to the association.

DSA is a trade association representing 115 direct selling companies and another 105 firms that supply goods and services to direct sellers. Companies within the industry market are a wide variety of consumer products and services. In any given year, over 4 million people engage in direct selling in the United States, with at least 2 million active in the business at any given time. Because of the independent contractor relationship, direct selling is a field open to everyone, with virtually no barriers to entry; 80 percent of direct salespeople are women. During any year more than 600,000 are minorities, 200,000 are over 65, and 400,000 have disabilities. The overwhelming majority—89 percent—work part-time, and nearly two-thirds work less than 10 hours per week. We are grateful for the opportunity to testify in favor of the enactment of Senate bill 2369, the Independent Contractor Tax Classification and Compliance Act of 1982.

DSA favors enactment of S. 2369 because it deals with two areas of concern. One being the desire of our industry to determine once and for all who is and is not an independent contractor. And it deals with the perceived nontax-compliance of independent contractors, which has never been adequately documented.

Our industry favors the safe harbor provisions because they clear up a longstanding controversy resulting from the IRS efforts in the 1970's to place new interpretations on the common law control test. This IRS effort actually drove some direct selling companies out of business who didn't have the resources to fight. A test case for direct sellers was Aparacor, decided in favor of the independent contractors' status of direct sellers.

The bill, as I said, would clear up through its safe harbor tests this uncertainty, and yet retain the common law test. The independent contractors' status is extremely important to the industry and to those affiliated with direct selling companies. In fact, a Lou Harris study showed that independents were the crucial factor amongst these persons selling our industry's products. They rated it even above the income received.

On the compliance issue, direct selling has a long history of cooperation with the IRS to encourage voluntary tax compliance. Direct sales companies supply extensive information to their independent contractors concerning their Federal tax obligations and proper deductions. Those individuals engaged in direct selling have an excellent tax compliance record.

In the case of my own company, Mary Kay Cosmetics, we send periodic notices around tax season. And furnish to our independent contractors a discount coupon which they may take to Beneficial Finance to have their tax returns prepared at a discounted price.

The IRS attempted in 1979 to document the nontax compliance of independent contractors. However, this study was fundamentally flawed. In this connection, I call your attention to attachment 1 of our formally filed testimony, pointing out succinctly the findings of Robert R. Nathan as to the inadequacy of that attempt. As you will see from it, even assuming the accuracy of the IRS study—and I believe this was admitted in Treasury testimony today—the Nathan firm estimated that 85 to 90 percent of taxes of direct sellers had been paid.

DSA has also consistently endorsed stronger penalty provisions for nonfiling of information returns. However, we are concerned that the penalty provisions of S. 2369 may be unintentionally excessive in three respects. There's a need for a dollar limit on first offenses, double penalties on reporting on commission payments and gross sales transactions should be eliminated. And reporting of noncash compensation should be the subject of a special rule.

Although in the past DSA has opposed the enactment of reporting requirements on buy-sell direct sellers as unduly extensive and burdensome with little associated revenue gain, in deference to Senator Dole, good faith efforts to find an overall solution to the independent contractor issue, we are now prepared to support the new reporting burden on direct sellers provided the alternative approach of the bill is retained.

We strongly oppose Treasury's proposal for use of only the $100 1099 and the $100 purchase requirement as generating millions of pieces of useless paper.

Our support, then, for S. 2369 is predicated on the enactment of the safe harbor provisions, retention of a common law, and the alternative information reporting.

Thank you.

[The prepared statement follows:]

TESTIMONY OF DIRECT SELLING ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

My name is Monty Barber. I am Vice Chairman of the Board of Directors of the Direct Selling Association (DSA) and Vice President and General Counsel of Mary Kay Cosmetics, Inc. With me today are Neil H. Offen, President of DSA, John C. Beyer, President of Robert R. Nathan Associates, Inc. (RRNA), and Arthur J. Rothkopf of the Washington law firm of Hogan & Hartson, who serves as tax counsel to the Association. We are grateful for this opportunity to testify in favor of the enactment of S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982.

The Direct Selling Industry

The Direct Selling Association is a trade association representing 115 direct selling companies and another 105 firms that supply goods or services to direct selling companies. In addition, more than 4 million independent salespeople who market the products of direct selling companies are affiliate members of DSA. Direct selling is a method of distribution through which products and services are marketed directly to consumers in their homes. Companies within the industry market a wide variety of consumer products and services: household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, home improvement products and services, food, vitamins, and so forth. The majority of companies within the industry qualify as small businesses. In 1980, total industry sales approximated $7.5 billion at retail.

But more important than the characteristics of the direct selling companies are the characteristics of the individual entrepreneurs who do business with the companies. There are virtually no barriers or requirements for entry into direct selling. It is a field open to any American. It provides flexible income-earning opportunities. For example, there are no demands that direct salespeople spend a given number of hours or sell at any particular time. For those reasons, direct selling has wide appeal among women who have significant family responsibilities.

The flexibility of the industry and ease of entry also attract substantial numbers of minorities, the handicapped, and the elderly. In any year, over four million people engage in direct selling in the United States, with at least two million active in the business at any given time. Eighty percent of direct salespeople are women. Further, during any year, more than 600,000 are minorities, 200,000 are over 65, and 400,000 have disabilities. The overwhelming majority of these salespeople -- 89 percent -- work part-time and nearly two-thirds work less than ten hours per week.

For most direct salespeople, selling is not seen as a "job" but as an additional earning opportunity -- a way for many people with modest or fixed incomes to supplement their earnings and make ends meet. Many direct salespeople sell intermittently and for different companies, establishing short-term specific earning goals and then terminating their sales activity when the goals are met. This way of doing business, which is foreign to an employer-employee relationship, helps to account for the industry's high turnover rate, which is in excess of 100 percent each year.

Simply stated, direct selling is an ideal way for some of these people to earn extra money without past business experience, without substantial capital, and without having to make a full-time commitment to an employer. Direct selling is also an excellent way for individuals to establish full-time career opportunities after first working on a part-time basis. Those who devote more time will obviously earn more from direct selling. Thus, 10 percent of those engaged in direct selling earn 63 percent of total income.

The Role of Independent Contractors in Direct Selling

The people who sell the products of direct selling companies have traditionally operated as independent contractors for reasons that are fundamental to the structure of the industry. The motivation of direct salespeople is directly related to the fact that they in effect have their own business: they control the hours they work, they conduct business away from any office or other fixed location, they keep their own records and books, frequently they maintain their own inventories, and they pay their own expenses. Direct salespeople are, by any objective assessment, independent businesspeople and operate in the same fashion as retailers throughout the country, except for the fact that they bring their products to the home of the consumer and do not operate from any fixed retail location. They do not perceive themselves as employees, nor do they wish to be so treated. They generally sell to their peers within their own communities, to their friends and neighbors. Each year they contact three out of every four homes in America. According to a Lou Harris study, 8 percent of the homes in this nation today include someone who will be a direct salesperson during the year, and an additional 15 percent of America's homes have someone in the home who had previously acted as a direct salesperson.

The independence of the operations of direct salespeople is a crucial factor in the decisions of individuals to become direct salespeople. Our Lou Harris study of direct salespeople found that they rated their own independence, being their own bosses, as the most important element of their sales work, even more important than the specific income they received, which was a close second. This person who sees himself or herself as an independent businessperson is the heart of the direct sales industry.

The success of direct selling companies is a function of the size and capability of their sales forces. Each company strives to expand its sales force, and competition among direct sales companies for salespeople is keen. Consequently, direct selling companies minimize their additional fixed costs for increasing the size of their sales force and create wide opportunities for marginal workers to enter direct selling. The increased size of the sales force and the minimal administrative costs associated with adding salespersons are key economic factors in the growth of direct selling. The independent contractor relationship is crucial to minimizing personnel costs and maximizing opportunities available. The relationships between direct selling companies and their salespeople are also extremely sensitive, especially with new recruits. Experience within the industry demonstrates that changing any aspects of these relationships or imposing additional administrative or other burdens will produce severe adverse consequences to the industry.

The use of independent contractors is fundamental to the structure of the direct selling industry. For tax purposes the Internal Revenue Code has long respected this status of independent contractors as determined under the common law. Traditionally, in the direct selling industry the tests for that status imposed by the common law were clearly met, and direct salespeople were treated as independent contractors for tax purposes without substantial dispute.

However, during the 1970's the Internal Revenue Service adopted an increasingly aggressive and unjustified audit position of challenging the independent contractor status of a broad group of individuals, including some direct salespeople. The most prominent example, and the test case, in the direct selling industry involved Queen's-Way to Fashion, Inc., a direct selling company subsequently renamed Aparacor, Inc. The IRS challenge culminated in a decision by the U.S. Court of Claims (Aparacor, Inc. v. United States, 556 F.2d 1004, 1977). In that case the

Court sustained the independent contractor status of the direct salespeople and stated that the IRS assessment "represents a radical departure from the traditional common law concept" (556 F.2d at 1012). While the company won the case, it was a costly victory; the company's growth and development were set back for years pending the outcome of the litigation.*/

The unjustified attacks on the independent contractor status of direct salespeople illustrated in the Aparacor, Inc. case cannot only immobilize a company's operations, but also create huge retroactive assessments which can jeopardize the financial well-being of a direct selling company. In challenging a company's treatment of individuals as independent contractors, the IRS assesses the company for the full amount of income taxes which it asserts should have been withheld were all its independent contractors treated as employees, plus both the employee and employer share of FICA taxes and FUTA taxes. These amounts have been assessed in many cases even though the individual treated as an independent contractor has in fact paid the full amount of income taxes and self-employment taxes which he or she owed. In these cases, the IRS assessments have resulted in double tax, since income taxes for the same individual would both be paid by that individual and the company, and similarly both FICA and self-employment taxes would be paid. In order for the company to reduce this double tax, it has the burden of locating its reclassified independent contractors and obtaining from them information regarding their tax payments; the IRS refuses to assist the companies in this regard.

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*/ A second case, involving Beeline Fashions, Inc., was subsequently settled to the company's satisfaction, permitting the company to continue its previously established independent contractor treatment of its salespeople.

Fortunately for the direct selling industry and its independent contractors, the IRS has had no success in attempting to reclassify direct salespeople as employees. However, continued IRS excesses in seeking to reclassify independent contractors generally led to the enactment of § 530 of the Revenue Act of 1978, which placed a moratorium on IRS enforcement and regulatory activities in the independent contractor area, pending action by Congress.

Since the enactment of § 530 and through the period covered by the two extensions, DSA has encouraged the Congress to enact reasonable safe-harbor standards for determining the status of independent contractors. Direct selling companies believe that the enactment of a reasonable safe-harbor, provided that the common law is available in the event that the safe-harbor is not satisfied, would be a major step forward in helping to resolve the expensive and prolonged controversies that have arisen over who is or is not an independent contractor. Accordingly, DSA supported enactment of the legislation introduced by Senator Dole earlier in this Congress as S. 8, and it supports enactment of S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982.

DSA wishes to commend Senator Dole for his efforts in developing legislation to provide a responsible safe harbor classification rule for determining independent contractor status without imposition of a draconian, and in the case of direct sellers, unworkable withholding program. DSA has long held to the view that it is in the national interest to develop a permanent solution to the classification issue for independent contractors and that such a solution in the form of a safe-harbor bill should be enacted as part of legislation which did not resort to withholding on independent contractors. While there are certain compliance provisions of S. 2369 which are quite burdensome on numerous direct selling companies, we are prepared to support the bill in order to resolve the issue on a substantive basis. We believe that Senator Dole's efforts in drafting legislation in consultation with the Treasury Department and the Internal Revenue Service, as well as with interested members of the public, has produced a constructive, realistic and responsible piece of legislation which, while imposing significant new information reporting burdens solely on direct sellers and including more severe penalty provisions than under current law, is acceptable to DSA. We urge that Congress speedily enact S. 2369.

Compliance of Direct Sellers

The direct selling industry believes that those individuals engaged in direct selling have an excellent tax compliance record. On both an ethical as well as legal basis, direct salespeople, like other self-employed taxpayers, should pay their taxes and report proper business deductions, and we are convinced that they do so.

Our industry has had a long history of cooperation with the Internal Revenue Service to encourage voluntary compliance on the part of direct selling companies and their salespeople. Over the past ten years, many meetings have been held with Internal Revenue Service personnel, almost invariably at the instance of DSA, to determine additional ways in which the compliance levels of those engaged in direct selling could be improved. These efforts on the part of the industry have not gone unnoticed, as reflected in a letter, dated October 17, 1977, from the Office of the Commissioner of the Internal Revenue Service, which acknowledged "a history of concern and cooperation on the part of the Direct Selling Association with the Internal Revenue Service in our cooperative efforts to promote voluntary compliance." These efforts over a period of many years have borne fruit in an extensive educational program engaged in by direct selling companies to assist and encourage their salespeople to fully and accurately report their income and deductions attributable to direct selling. DSA's member companies have an excellent record of distributing to their salespeople detailed information on a frequent basis that explains to the salespeople their federal income and employment tax responsibilities. This written material demonstrates a real concern on the part of the companies for tax compliance, which we believe is reflected in an excellent compliance record on the part of those who are engaged in direct selling.

In 1979, the Internal Revenue Service prepared a study which purported to show that independent contractors in general, including direct sellers, had low levels of tax compliance. Robert R. Nathan appeared before the Congress in 1979 and presented a detailed assessment prepared by his firm which demonstrated the fundamentally flawed manner in which this IRS study was conducted. His conclusion then, as it remains today, was that the IRS study was so deficient in design that no meaningful conclusions should be drawn concerning compliance of independent contractors generally and of direct salespersons in particular. I think it should be noted that it is highly doubtful that the direct selling industry was appropriately represented in the study, and, in fact, no member company of DSA is aware of any of their direct salespersons who were incorporated in the study. (See Attachment 1.)

Notwithstanding the absence of any credible, objective data, IRS officials continue to claim that independent contractor and direct selling tax compliance is poor. We completely reject that conclusion. For example, even assuming for purposes of analysis that the results of the 1979 IRS study were correct (which we do not accept), the Nathan firm has estimated (based on that IRS study) that 85-90 percent of the taxes owed by independent contractors and direct sellers were paid.

Because of this compliance record, I and others in the direct selling industry are deeply disturbed by the effort of the IRS to link direct salespersons and the so-called "underground economy" or the "tax compliance gap." To associate in any way direct salespersons as being a major factor in the IRS's estimate of $26 billion of unpaid taxes by self-employed persons is completely inappropriate. In response to our concern, Robert R. Nathan Associates has undertaken further analysis to determine total unpaid taxes for a recent year for all direct salespersons. The results of this analysis, based on data for 1980, show potential unpaid taxes for all direct salespersons of only $35 million, and in fact, we believe that this number overstates unpaid taxes. (See Attachment 2.) Given the size of the industry, the number of people engaged in direct selling and net income of all direct salespeople of $1.3 billion, this possible unpaid tax figure is truly a nominal one. Moreover, through the new compliance measures in S. 2369 and industry initiatives in taxpayer education, it is expected that this nominal figure will be reduced even further in the future.

S. 2369

Safe-Harbor Provisions: The Direct Selling Association strongly supports the enactment of the classification provisions of S. 2369. It is our belief that this bill deals with the independent contractor classification question in a judicious and reasonable manner by establishing a safe-harbor to provide certainty for the Government, direct selling companies and individual independent contractors. The legislation was carefully drafted to permit traditional independent contractors to continue in that status without fear of harassment from the Internal Revenue Service. Those industries that are unable to meet the safe-harbor standards of this legislation would continue to be judged under the traditional common law standards. The legislation would have the effect of eliminating a great deal of the controversy that has characterized this issue prior to the enactment of S 530 in 1978.

The bill would require that persons seeking to take advantage of the safe-harbor meet both a control-of-hours test and a place-of-business test, and in addition, satisfy either an investment or income fluctuation test. These factors are the key elements of the traditional common law requirements for independent contractor status, and therefore, appropriately form the basis for a safe-harbor standard. In addition, S. 2369 requires that a written contract be entered into between the independent contractor and the company for whom the services are performed, and that the independent contractor be furnished a written notice of his or her tax responsibilities at the time the contract is executed. Moreover, in order for the safe-harbor test to apply, all required information returns would have to be filed. We believe that this legislation represents a fair and workable effort to prescribe the most significant standards in determining whether an individual is an independent contractor, and accordingly, we urge its enactment.

We must emphasize, however, that the support of DSA for the classification provisions of S. 2369 is based on its safe-harbor approach. DSA would oppose this or any other bill which would replace the common law with a specified statutory test or presumption. By preserving the common law means for attaining independent contractor status, the bill retains the flexibility that the common law provides -- so that new companies and new ways of doing busines can be accommodated as they arise. This flexibility is, in our view, crucial to any status determination for tax purposes and is important to the well-being of our economy.

We thus support the classification provisions of S. 2369 because it permits those companies desiring certainty against IRS challenge to have that certainty if its safe-harbor requirements are met. At the same time, the bill avoids forcing companies and independent business people into arbitrary and restrictive methods of operation in order to remain independent contractors. Moreover, the legislation will free IRS personnel from pursuing classification issues and permit them to focus their attentions on non-filers and those filing fraudulent returns.

Compliance Provisions: S. 2369 contains various provisions designed to improve tax compliance among independent contractors. While we have concerns about certain of these provisions, we are most encouraged by the fact that they seek to deal with the subject of improved tax compliance without resorting to the requirement of withholding on independent contractors, except in the limited case in which an independent contractor fails to furnish a taxpayer identification number or furnishes an incorrect number. We understand that many information returns filed by payors do not include any taxpayer identification number or include an incorrect number. Often there is little the payor can do about this. We recognize that the failure to include correct taxpayer identification numbers on Forms 1099 makes it extremely difficult, if not impossible, for the IRS information reporting system to operate properly. Therefore, while we have concern about the imposition of withholding on independent contractors in any circumstance, we do not object to the withholding provisions of S. 2369 in those instances in which either no taxpayer identification number or an incorrect number is provided, and notice is given to the payee with the opportunity to supply a proper identification number.

S. 2369 provides for much stricter penalties than under current law for the failure to provide to the Internal Revenue Service information returns on payments to independent contractors and for the failure to provide copies of such returns to the independent contractor. DSA has consistently supported increased penalties for the failure to provide Forms 1099 where required.

However, we are concerned that these penalty provisions may be excessive. They could result in a penalty equal to 30 percent of the amount of remuneration subject to reporting requirements, even in the case of a first offense. In light of the vagueness of the "reasonable cause" exception, we suggest that consideration be given to placing a dollar limit on a first offense for violating these information reporting requirements. We also believe that the penalty provisions applicable to information returns on commissions and the penalty provisions applicable to the new direct seller buy-sell information returns could produce penalties in excess of 30 percent of the remuneration arising from the same transactions. We believe that this is an unintended, overly harsh result and urge that it be clarified accordingly. Finally, we suggest that consideration be given to limiting the penalty provisions' applicability to non-cash compensation where legitimate disputes may arise over value, but where the potential for extremely severe penalties exists.

The compliance provision of S. 2369 will be most burdensome in requiring that an annual report be filed by direct sellers reflecting sales of products for resale in the home to any buyer on a buy-sell or deposit-commission basis, where the amount of sales to a particular buyer during the calendar year is $5,000 or more. This reporting requirement would be in addition to the existing requirement that information returns be filed on remuneration paid in excess of $600 during the calendar year. In the alternative, the bill would permit an election by a direct seller to furnish more information on commissions, sales bonuses and other remuneration paid (by reducing the threshold for reporting such remuneration from $600 to $50) and by furnishing certain information identifying those individuals purchasing goods for resale in excess of $50 during the year.

DSA has in the past strongly opposed the enactment of reporting provisions that would require companies operating on a buy-sell basis to furnish gross sales data on the grounds that the added burden and costs resulting from this additional information reporting would not be justified by any additional revenue that might be achieved. However, notwithstanding the severe reservations which DSA has about the adoption of specific new information reporting requirements solely on direct sellers, DSA supports the direct sales reporting requirements of S. 2369 in order to achieve a final resolution of the classification issue. We wish to emphasize that we are willing to support these new reporting requirements in deference to the good faith efforts of Senator Dole to find an overall solution to the complex problems inherent in the independent contractor issue. We should note that to some direct selling companies the gross sales reporting method of the bill would be preferable because of the extreme reporting burden of reporting remuneration at the $50 level. Other companies, because of their structure, would prefer the reduced Form 1099 reporting alternative. Therefore, there is need for an alternative reporting system and maintaining this option is crucial to our support of this legislation. In summary, the new reporting system will be expensive and painful to many of our companies, but we can support it provided that (1) the alternative approach of the bill is retained and (2) the provision is included as part of a safe-harbor classification bill along the lines of S. 2369.

Procedural Issues

In his floor statement introducing S. 2369, Senator Dole invited comment on the procedural problems incurred by taxpayers when they are the subject of IRS reclassification actions. While enactment of the safe-harbor provisions of S. 2369 will limit the number of classification controversies, they will still arise and DSA has long believed that reform in this area is overdue. The severe financial problems incurred by DSA members in litigating with the IRS on classification questions before the moratorium was enacted demonstrates the clear need for procedural change.

We urge that the Subcommittee give consideration to the adoption of a rule that limits considerably the amount that may be claimed by the IRS in an employment controversy, provided that a reasonable basis for the classification existed. We also believe that there should be taxpayer access to the Tax Court or some other form of judicial relief that does not require the disputed taxes or a large bond to be posted as a pre-condition to litigation.

We know that the Committee staff has been focusing on these important procedural questions and we would be pleased to give our more detailed views on these issues to the staff.

Conclusion

We wish to commend Senator Dole for his efforts in developing a compromise piece of legislation that deals in a responsible way with the most important issues in the independent contractor area. As a result of the overreaching of the Internal Revenue Service, we have been in a state of uncertainty for several years. DSA believes that the time has come to end the moratorium and for permanent legislation to be enacted determining who is and who is not an independent contractor. We strongly favor the safe-harbor provisions of S. 2369. While there are compliance provisions in S. 2369 which we would prefer be modified (and which we hope will be modified), we are firmly in support of the enactment of the legislation since we believe it represents constructive and responsible legislation that will end the uncertainty in this area and permit the tax laws to be administered in a manner that will be beneficial both to Government and private industry.

We urge that this Subcommittee act promptly to report S. 2369 favorably.

RRNA
CONSULTING ECONOMISTS

Attachment 1

DEFECTS IN THE IRS COMPLIANCE STUDY

The Treasury proposal to extend tax withholding to independent contractors is based on an IRS compliance study of 5,152 individuals which concludes that tax compliance for independent contractors is poor. This study and the conclusions drawn from it are too seriously flawed to serve as the basis for such a fundamental tax change.

The IRS Failed to Estimate Compliance Rates Correctly

- The IRS failed to compare taxes paid on independent contractor income to total taxes owed. Using the IRS's own data for the 5,152 workers in the study, it is estimated that 90% of the taxes owed on this income have been paid. Failure to measure this most basic and meaningful compliance rate is a serious flaw in the IRS study.
- The IRS failed to utilize net income as the most appropriate measure for calculating compliance rates, resulting in an overstatement of non-compliance.
- The IRS failed to include in the compliance estimates individuals whose total income was below the level of that required for filing returns. This resulted in further overstatement of non-compliance.
- The IRS failed to measure tax compliance where information returns (Forms 1099) are furnished to independent contractors. Such a correlation would have indicated whether better information reporting would lead to increased compliance.
- The IRS included as non-compliers a large number of workers (estimated to be almost 20% of the sample) whom the IRS found had no tax liability as independent contractors.

Even The IRS Data Demonstrate That Additional Revenue From Tax Withholding Will Be Small

- The Treasury has stated that withholding and strengthened information reporting would raise the tax compliance rate to approximately 90%, but the IRS study supports the conclusion that the tax compliance rate for independent contractors is already at that level.

The IRS study shows that additional revenue would come from a very small proportion of independent contractors.

- Two-thirds of the audited workers had no unpaid taxes.
- Four-fifths had an average unpaid tax of only $8.32.
- Fourteen percent of the audited workers account for 87 percent of the unpaid tax.

The Overall Design Of The Study Is Highly Deficient

The sample of individuals audited is not representative of independent contractors.

- The universe of independent contractors is not known, which the Treasury explicitly admits.
- The sample of workers was drawn only from tax cases where employment status was under dispute.
- The sample of audited workers was drawn from a larger sample which the Treasury has stated is not representative of independent contractors.
    - Over one-third of the workers were drawn from insurance salespersons, which does not reflect the composition of the independent contractor population.
    - The "Direct Sales" category includes workers with occupations foreign to the industry -- entertainers, drivers and a large number of unskilled laborers.
- The sample was not random. Over 21 percent of the original sample could not be located and was not replaced, contributing to sample bias.
- The large number of skilled and unskilled workers in the sample (almost one-half) is not consistent with the known characteristics of independent contractors.

Acceptable measures of statistical reliability have not been provided, so that the reliability of the compliance rates are not known.

For many industry and occupational groupings in the study, the number of workers audited is too small to estimate compliance with statistical reliability.

RRNA
CONSULTING ECONOMISTS

Attachment 2

AN ESTIMATE OF UNPAID TAXES OF DIRECT SALESPERSONS IN 1980*

Retail sales	$7,500 million
less: personal use	1,837 million
Salespersons' business receipts	5,663 million
less: cost of sales	3,933 million
Salespersons' gross income	1,730 million
less: business deductions	433 million
Salespersons' net income	1,297 million
Salespersons' tax liability	233 million
Unpaid tax	35 million

*This estimate is based on:

(1) Personal use of 24.5 percent of retail sales determined from industry survey.

(2) Average markup over wholesale of 44 percent determined from industry survey.

(3) Assumption of business expenses at 25 percent of gross income.

(4) Average marginal tax rate of 18 percent, determined from data in IRS, Statistics of Income Bulletin and based on average total household income of direct salespersons.

(5) Assumption of tax compliance rate of 85 percent based on 1979 IRS Compliance Study.

Senator Grassley. Thank you all very much. I will defer to Senator Dole for questioning.

Senator Dole. I may have some questions to submit again to the panel. But I appreciate your testimony. And I assume we can direct those questions to either Gil or Mr. Offen. We thank you very much.

Senator Grassley. If Congress can't resolve this issue—and I don't insinuate that we can't get it resolved—but I suppose all of you would want the moratorium to be extended.

Mr. Lehr. It's either that, Senator, or we will be back in the courts, where we were when you enacted the moratorium in 1978. I think this is an issue that has to be resolved by the Congress. And we would hope that if there is not time or resolution can't be handled in this session that, yes, the moratorium would be extended.

Mr. Barber. Obviously, we feel a great deal of effort from many people has gone into this bill. But if it were impossible to get it enacted, we would support the moratorium.

Mr. Roberts. We agree.

Senator Grassley. Do your workers prefer to be independent contractors or employees? I don't know whether it's the same for all of you, but I guess I would like to have each association respond.

Mr. Lehr. Ours are insurance agents, and I have been the president of my companies for about 10 months now. And I have learned what the "independent" in independent contractor means. Yes, Senator, indeed they prefer to be independent contractors.

Mr. Roberts. In our case, the same applies, Mr. Chairman. The people who work in our shop are always in the field. They work their own hours. They call their own shots. And they prefer to have it that way. We are almost like the other witnesses. Our independent contractors are encouraged to work at their own speed and at their own schedule. And they like that very much.

Mr. Barber. Yes, sir. They are very proud of being independent contractors. As we indicated, the Lou Harris survey data formalized indicated that they do prefer being independent contractors. Many women are direct sellers and they prefer the flexibility of hours that enables them to meet family obligations—children, home, school, and that sort of thing.

Mr. Offen. Senator, because of the independent contractor nature of the relationship, we can make the opportunity for income available to these 4 to 5 million sales people who are affiliated with our companies. Fundamental to the availability of that opportunity, that the independent contractor status be maintained since a person working a few hours a week as an independent contractor can be productive but not as an employee. And so we have found that according to our economist, Mr. Nathan, and his colleagues that if the independent contractor status was denied us, was reversed, we would probably wind up with a loss of two-thirds of our 4 million sales people who could not be commuted into, converted into an employee status.

Senator Grassley. This question pertains to the place of business requirement, which is one of the tests in Senator Dole's safe harbor. The test requires the worker must have a different principal place of business than the recipient. There is an exception though for individuals who have the same principal place of business but perform substantially their service at some other place. Will this exception include most of your members?

Mr. **Lehr**. Not our company, Senator. No. Out of 1,250 agents, we have perhaps 3 or 4 who are renting space in company-owned buildings. Other than that, each one of them has their own offices.

Mr. **Roberts**. Most of our people are working in the field where they perform their services. The description that is in the bill would fit our people very well.

Mr. **Barber**. The place of business test, as it stands, is a very acceptable test to direct sellers. We would not like the place of business test proposed by Treasury.

Senator **Grassley**. But, Mr. Lehr, were you taking exception to the——

Mr. **Lehr**. No, sir. No, sir.

Senator **Grassley**. OK. One of you already spoke to the alternative in the bill on reporting. The reporting requirements for direct sellers give them an alternative as to which information to report. Will the existence of an alternative means to induce compliance——

Mr. **Barber**. No, sir. The reason for the insistence on the alternative is due to the complexity of the structure of many direct selling companies. Many direct selling companies have the direct relationship with those selling their products while others lose track, if you will, of the product as they pass through different wholesale levels. And some companies are hesitant to impose on these various small and unsophisticated people very burdensome reporting requirements. And by preserving the alternative, we think both of those needs can be met.

Senator **Grassley**. Mr. Roberts.

Mr. **Roberts**. Well, all of our people would fall under the classification of using form 1099 so it would not affect our people in the way it would affect direct sellers.

Mr. **Lehr**. Same situation for us.

Senator **Grassley**. All right.

[Pause.]

Senator **Grassley**. In the controversies of the 1960's and 1970's on this issue, were both the IRS and most businesses trying to classify workers in good faith reliance on differing legal interpretations? Has this controversy been the result of substantial amounts of abusive or overzealous conduct on either side? Or is the problem here primarily one of lack of clarity in the law?

Mr. **Barber**. Thank you, Senator. I don't think that they were attempting to classify people under differing legal interpretations, Senator. They were relying on the common law test which had tremendous precedent behind it since the 1700's. And those control tests had been met in many instances. Also many direct selling companies had revenue rulings which were that their people were independent contractors which were suddenly considered no longer valid. I don't think that the companies perceived any particular amounts of abuse, to answer your question. And the lack of certainty, if you will, was injected into the issue by the Internal Revenue Service.

Mr. **Offen**. The court in the test case in our industry in the Aparacor, indicated that the Service had made a radical departure from the common law. And held against the Service for its reclassification of independent contractors and to employees in our test case.

Mr. **Roberts**. In the case of our independent real estate contractor sales people, the courts frequently ruled that they were independent contractors. And it was established by numerous court proceedings that that was actually the case. It was the concern of IRS that they were and are misinterpreting the common law interpretation of what an independent contractor is supposed to be. And the threat of retroactive assessments and the other impositions that IRS was attempting to make in this area were a matter of their interpretation of the law as opposed to ours. The bill will clarify the law, Senator. And in response to your other question, the bill will clarify the issue and put that matter to rest.

Mr. **Lehr**. I think you were out for a minute when I commented on the circumstances of our companies which were organized in 1946. And until 1972, it had never been an issue. We had never given it any consideration. We had been repeatedly audited, and we had had many Keogh plans of our agents that had been approved by the Internal Revenue Service. We had a pension plan for our employees that had been approved. In 1972, suddenly, with what we think are the same facts that had existed for the 25 previous years, they took the position that these people are no longer independent contractors; they are employees. We have been at it ever since. I wouldn't want to characterize any motives or what have you, but it did come kind of as a bolt from the blue.

Senator **Grassley**. The GAO, in their testimony today, suggested that the income fluctuation test requires that the worker also risk economic loss. How would such a requirement affect your industry, your associates, and your workers?

Mr. **Barber**. Well, we feel that's a valid test, because the direct selling industry income does fluctuate substantially. And they do risk economic loss as do other small business people beginning a business perhaps. I doubt that there is very much loss.

Mr. **Offen**. One of the things, Senator, that we would vehemently oppose would be a denying of the income earning opportunities by taking away the independent contractors' status on the basis that people aren't making a major capital investment. We think one of the beauties of our industry is that we are small, small, and that people can get into the business without a major capital investment. While they do risk income fluctuation, we would not like to be at the mercy of IRS regulations spelling out that certain dollar amounts of loss have to be incurred to qualify as an independent contractor.

Mr. **Roberts**. So far as the real estate industry is concerned it is common knowledge these days that we are in a pretty bad situation as far as the market is concerned. That, in itself, is self-proving that our people have placed at risk their own economic stability, so that should not be a question as far as the interpretation is concerned in the real estate field.

Mr. **Lehr**. In the insurance industry, we find problems with that particular proposal of the GAO. Our people do not make a substantial capital investment other than office furniture and what have you. However, being compensated purely on commission, there is as great an economic loss there, I would think, as there would be in requiring carrying inventory and perhaps substantial investment. So we think the test, as proposed, covers the gambit of the independent contractors in all industries, and to limit this to an economic loss, which I took to mean losing one's investment in inventory, or something, would not be satisfactory.

Mr. **Barber**. To give you a little bit of perspective of the small, small business that Mr. Offen was talking about, the Robert Nathan study revealed that the median income of direct sellers was under $600 per year.

Senator **Grassley**. Of course, I haven't studied the issue yet on the amount of investment you have to have for a risk, but it seems to me that it would be somewhat in proportion to the income that you might have.

I think that's all the questions I have. Thank you very much for your participation.

Mr. **Lehr**. Thank you, Senator.

Senator **Grassley**. Our next panel, again, has three participants. The first person is Duncan McRae, Jr., who is vice president of Melton Truck Lines, Shreveport, La., and Mr. McRae is speaking on behalf of the American Trucking Associations, whose headquarters are in Washington, D.C. Our second participant is G. Zan Golden, senior vice president, North American Van Lines, on behalf of the American Movers Conference, with offices in Washington, D.C., and the third participant is K. S. Rolston, president of the American Pulpwood Association, Washington, D.C.

I would ask that you gentlemen would proceed as I introduced you. If you will introduce your colleagues or associates that you have with you for the record, we would appreciate it.

STATEMENT OF DUNCAN McRAE, JR., VICE PRESIDENT, MELTON TRUCK LINES, INC., SHREVEPORT, LA., ON BEHALF OF THE AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, D.C.

Mr. **McRae**. Thank you, Mr. Chairman. My name is Duncan McRae, Jr. I am with Melton Truck Lines in Shreveport. I am accompanied by Edward Delaney, Washington, our special counsel. We appear today on behalf of the American Trucking Associations, and we appreciate the opportunity to participate in the hearings of this subcommittee.

ATA is the national organization of the trucking industry representing all types of motor carriers of freight both for hire and private. The effectiveness of the motor transport system existing in this country today is in no small measure the result of the dedication of these independent operators. This dedication comes from the fact that the independent truck operator is an independent businessman in control of his own work habits, and, to that extent, in control of his own destiny.

The trucking industry has found the common law to be instructive in determining an independent operator's status as an independent contractor. We urge that the common law, in this regard, not be tampered with. This common law is based on a 1947 decision of the Supreme Court of the United States.

Nevertheless, we are fully aware of the attack by the Internal Revenue Service during the 1970's upon the small businessman's status as an independent contractor. Therefore, we support a legislative effort to establish certain so-called statutory safe harbor rules based upon the common law in addition to the common law rule of section 3121 of the Internal Revenue Code to determine an independent operator's status as an independent contractor.

Independent truck operators generally own their own power equipment. A relatively small percentage lease their equipment from a carrier or a third party. In either case, the independent operators control their day-to-day operations subject to the regulatory requirements of the Interstate Commerce Commission, the Department of Transportation, and other Federal, as well as State, agencies. They are not supervised in their daily routine by the motor carrier. Many independent operators haul freight over long distances across the country. Some may go for many days or weeks with the only contact with the motor carrier being a telephone call to find freight to haul or to advise of delivery. Independent operators bear their own operating expenses. It is important to note that these operating expenses are substantial, estimated in many instances to be at least 70 percent of his gross revenue.

Independent truck operators provide all the necessary labor. Many independent operators who own only one rig operate the equipment themselves. Some do hire drivers. Independent operators who own a fleet of trucks may employ a substantial work force including drivers, drivers' assistants, mechanics, and other office personnel. In addition to labor expenses, major expenses borne by the independent truck operator in general include fuel, maintenance costs, finance costs, depreciation, collision insurance, highway tolls, State permits and license fees, and various Federal and State taxes.

Following the Supreme Court decision, the IRS established six guidelines to determine the independent contractor status of the independent truck operators. These are set forth on pages 9 and 10 of our written statement.

If and so long as the Internal Revenue Service applies the guidelines fairly and consistently, there would be no need for legislation insofar as the trucking industry is concerned. However, there is some indication that the IRS may be contemplating a change. Consequently, the legislative enactment of safe harbor rules, rules that take account of the operating practices of the trucking industry, including the moving industry, has the strong support of the trucking industry. We are firmly committed as an industry to the proposition that all should meet their tax obligations. A 1981 GAO report to the House Ways and Means Committee reflects a high level of compliance by independent truck operators with their obligations under the self-employment tax laws. An earlier Treasury statement showed a high level of compliance where gross income exceeds $50,000.

A study that we did and industry experience shows the average independent truck operator grosses more than $50,000. We, therefore, strongly object to the imposition of any withholding tax upon the revenues of the independent truck operators.

In our written statement, we have pointed out that past withholding tax proposals seriously harm owner-operators, and would far exceed their actual tax liability.

Our recommendations are, first, that the historical independent contractors' status of the motor carrier industry's truck operator be preserved. Two, that there be no withholding. Three, that Congress must enact S. 2369 with suggested changes.

Thank you very much, sir.

[The prepared statement follows:]

STATEMENT
OF
DUNCAN McRAE, JR.
ON BEHALF OF THE
AMERICAN TRUCKING ASSOCIATIONS, INC.

INTRODUCTION

My name is Duncan McRae, Jr., and I am Executive Vice President of Melton Truck Lines, Inc., 1129 Grimmet Drive, Shreveport, Louisiana 71107. I am accompanied by Edward N. Delaney, Washington, D.C., our special counsel. We appear today on behalf of the American Trucking Associations, Inc. (ATA), and we appreciate the opportunity to participate in the hearings of this Subcommittee.

ATA is the national organization of the trucking industry, a federation of associations in the 50 states and the District of Columbia, together with 13 national conferences which represent specialized types of motor carrier operations. As such, we represent all types of motor carriers of freight, both for-hire and private.

We urge that the historic status of "independent truck operators" as independent businessmen, exercising their entrepreneurial spirit and talents be continued.

Furthermore, we urge that the limited financial resources of these independent small businessmen not be further strained by imposing a withholding tax upon their receipts, which they so sorely need to meet the great demands imposed upon them by inflation and the fuel crisis, as well as other economic burdens.

The effectiveness of the motor transport system existing in this country today is in no small measure the result of the dedication of these "independent operators". This dedication comes from the fact that the "independent truck operator" is an independent businessman, in control of his own work habits, and to that extent in control of his own destiny.

The "independent truck operator" is the classic example of the American dream of owning your own business -- "working for yourself" -- and, therefore, is the prototype small businessman.

As the Subcommittee on Special Small Business Problems of the House of Representatives' Committee on Small Business noted (H. R. Rep. No. 95-1812, 95th Cong. 2nd Session, 1978):

> "Throughout the interstate motor carrier industry is a trucker who has been referred to as 'the last American cowboy'. The American public pictures him riding the range perched high in his cab, listening to country and western music. A close-up look at this adventurous trucker reveals an independent-styled small businessman

who is working hard to earn a decent
living for himself and his family."

Their continued existence as small businessmen, and the vitality of this country's motor transport system, which is so heavily dependent upon their entrepreneurial spirit, demands that the "independent truck operators" status as independent contractors, their historic status, be continued unimpaired.

The monthly cash demands imposed upon an independent operator are substantial. These demands reflect his cost of investment, maintenance of equipment, operating expenses and, of course, the support of his family. To subject the receipts of these independent small businessmen to an additional substantial expense, in the form of a withholding tax, without an adequate showing of need for such withholding by the Internal Revenue Service, will drive thousands of these entrepreneurs over the brink of financial disaster and out of business, to the great detriment of the motor carrier industry and the country.

The trucking industry has found the common law to be instructive in determining an "independent operators" status as an independent contractor. We urge that the common law in this regard not be tampered with.

Nevertheless, we are fully aware of the attack by the Internal Revenue Service during the 1970's upon the small businessman's status as an independent contractor. Therefore, we support a legislative effort to establish certain so-called statutory "safe harbor" rules based upon the common law, in addition to the common law rule of Section 3121 of the Internal Revenue Code (Code), to determine an "independent operators" status as an independent contractor.

As we understand S. 2369, the independent truck operator would be entitled to rely upon the common law tests in determining his status as an independent contractor, or alternatively, make use of the "safe harbor" rules to establish his status. Furthermore, it is our understanding that the common law rules and the "safe harbor" tests are not mutually exclusive -- an independent truck operator may use either in determining his status under the Federal tax laws.

It might be helpful to the Subcommittee if we briefly outlined the common law rules that have established the independent contractor status of independent truck operators.

INDEPENDENT TRUCK OPERATORS AS INDEPENDENT CONTRACTORS

For purposes of the Federal Insurance Contributions Act (FICA), section 3121(d)(2) of the Code defines the term employee to mean any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee, if the contract of service contemplates that substantially all of such services are to be performed personally by such individual. An exception to this rule is that an individual shall not be included in the term employee if such individual has a substantial investment in facilities used in connection with the performance of such services, other than facilities for transportation. The "other than facilities for transportation" was not intended to, and does not, encompass transportation facilities when they are an essential part of a trade or business.

This definition is in effect incorporated into the Federal Unemployment Tax Act (FUTA) and the Collection of Income Tax At Source On Wages law (Withholding Tax).

Independent truck operators generally own their own power units (the tractor); a relatively small percentage lease this equipment from a carrier or a third party. In either case, the independent operators control their own day-to-day operations, subject to the regulatory requirements of the Interstate Commerce Commission (ICC), the Department of Transportation (DOT), and other Federal as well as state agencies. They are not supervised in their daily routine by the motor carriers. Many independent operators haul freight over long distances across the country. Some may go for many days or weeks with the only contact with the motor carrier being a telephone call to find freight to haul or to advise of delivery.

Some independent operators own one unit of equipment; others may own a fleet, sometimes including as many as twenty or more units.

In general, independent operators are compensated by an agreed division with the motor carrier of the revenue paid by the shipper for the haul, or by a formula which takes into account the weight of the freight and/or the miles driven. Most of the revenue paid to the carrier -- usually from about 50 to 75 percent or more depending upon the commodities hauled or the equipment furnished by the independent truck operator -- is paid over to the independent truck operator pursuant to an agreement for the division of the revenue.

Independent operators bear their own operating expenses. It is important to note that these operating expenses are substantial, estimated in many instances to be at least 70 percent of the independent operator's gross revenue.

Independent truck operators provide all necessary labor. Many independent operators who own only one rig operate the equipment themselves, while some hire drivers. Independent operators who own a fleet of trucks may employ a substantial work force including drivers, drivers' assistants, mechanics, and office personnel.

In addition to labor expenses, major expenses borne by the independent truck operators in general include fuel and maintenance costs, finance costs, depreciation, collision insurance, highway tolls, state permit and license fees, and various Federal and state taxes.

The independent contractor status of independent truck operators for employment tax purposes was first challenged by the Internal Revenue Service in a series of cases in the 1940's. That controversy culminated in a Supreme Court decision, Harrison v. Greyvan Lines, Inc., 331 U.S. 704 (1947), which recognized the independent operators status as independent contractors. The Supreme Court's decision that these contractors are independent -- but not the Court's adoption of an "economic reality" test -- was expressly confirmed by Congress, which reaffirmed the "common law" test, in the 1948 and 1949 amendments to the Social Security Act. (S. Rep. No. 1255, 80th Cong., 2d Sess. 2, 4, 13, 16, 1948; H. R. Rep. No. 1300, 81st Cong., 1st Sess., 189-91,202-04, 1949).

The Internal Revenue Service acquiesced in the treatment of independent truck operators as independent contractors until the early 1970's, when it again began to challenge the relationship in a number of cases. The actions taken by the Service in 1972 and 1973 with respect to the trucking industry could serve as a model of the treatment of other industry groups.

In 1969 and 1970, the Service had reissued three Revenue Rulings which were based upon Social Security Tax rulings which had been issued in the 1930's. The 1969 and 1970 rulings are Rev. Rul. 69-349, 1969-1 C.B. 261; Rev. Rul. 70-441, 1970-2 C.B. 210; Rev. Rul. 70-602, 1970-2 C.B. 225. Although these rulings did not address the current pattern of operations, Revenue Agents began to rely upon them in asserting that an employment relationship existed in a number of cases. Huge retroactive assessments were proposed against the motor carriers involved.

It was at this point that the National Office of the Internal Revenue Service adopted a procedural method designed to resolve the cases fairly and equitably, and without the need for extended litigation.

As a first step, the National Office solicited the submission of approximately a dozen cases for Technical Advice. The cases were selected to represent a broad cross section of the trucking industry. The Service studied the operations of the carriers and the independent operators engaged by them. Working in cooperation with trucking industry groups, the Service issued a set of Guidelines [Internal Revenue Manual 46(10)(2)] by which agents were to determine the status of independent truck operators and carriers, and stated that there would be a "strong inference" of independent contractor status when these factors were present. The then-pending cases were resolved by reference to these Guidelines. Standard contracts between the carriers and independent operators were, in many instances, revised to make it clear that an independent contractor relationship existed in line with the Guidelines.

The Guidelines are written so that they can be easily understood and applied by examining agents as well as by motor carriers and independent operators. The overwhelming majority of employment tax cases involving the trucking industry have been resolved by reference to the Guidelines. The Guidelines have generally eliminated the turmoil caused by enormous proposed assessments and have enabled the independent operators and carriers within the trucking industry to go about their business with reasonable certainty that their independent contractor relationship will be respected for withholding and employment tax purposes.

The six factors identified by the Guidelines as creating a strong inference of the independent contractor status of the independent truck operators are:

1) The independent operator owns the equipment or holds it under a bona fide lease arrangement.
2) The independent operator is responsible for the maintenance of the equipment.
3) The independent operator bears the principal burdens of the operating costs, including fuel, repairs, supplies, insurance and personal expenses while on the road.

4) The independent operator is responsible for supplying the necessary personal services to operate the equipment.

5) The independent operator's compensation is based upon a division of the gross revenue or a fee based upon the distance of the haul, the weight of the goods, the number of deliveries, or a combination of these factors.

6) The independent operator generally determines the details and means of performing the services, in conformance with regulatory requirements, operating procedures of the carrier and specifications of the shipper.

The Internal Revenue Service concluded in Internal Revenue Manual 46(10)(2)(4) that:

> "The [six] factors [set forth above] give contract operators substantial opportunity for profit and loss and the risks of enterprise, which are indications of independent contractor relationships. Economic factors alone, however, are not conclusive when the company meaningfully controls the details and means used by the contract operators. Such controls do not include those which a carrier imposes upon its drivers in order to direct them as to the

results to be achieved. For instance, a company rule that drivers report regularly or frequently in a prescribed manner to receive work assignments should not be considered significant. In addition, operating requirements imposed by governmental regulations require that a carrier's name appear on the operator's equipment and, therefore, such identification is not evidence of company control."

THE PRESENT AND THE FUTURE

If, and so long as, the Internal Revenue Service (Service) applies the Guidelines fairly and consistently there would be no need for legislation insofar as the trucking industry is concerned.

However, we believe that there has been some movement by the Service away from the stability provided the industry by the Guidelines. We understand that the National Office of the Service had proposed in a Technical Advice memorandum involving a trucking case to find an employer-employee relationship, even though in substantially identical cases reviewed at the time when the Guidelines were issued the Service found that an independent contractor relationship existed.

Furthermore, there were some informal indications that the National Office of the Service was considering the issuance of a revenue ruling that would be a companion to Rev. Rul. 76-226, 1976-1 C.B. 322, but which would set forth certain facts and circumstances and conclude that the relationship involved was that of employer-employee rather than independent contractor. Rev. Rul. 76-226 applied the Guidelines and concluded that an independent contractor relationship existed, rather than an employer-employee relationship.

Shifting determinations by the Internal Revenue Service in other industries are the source of the problem. The "bracket ruling" concept -- one finding an independent contractor relationship and another finding an employer-employee relationship -- created a vast area of uncertainty in other industries, and resulted in the creation of a substantial number of controversies rather than putting cases to rest. While a "companion" ruling involving the trucking industry would not necessarily have the same effect, there is a potential for substantial confusion.

Consequently, the legislative enactment of "safe harbor" rules -- rules that take account of the operating practices of the trucking industry including the moving industry -- has the strong support of the trucking industry.

COMPLIANCE ISSUE

In oral and written testimony presented to a Subcommittee of the House of Representatives Committee on Ways and Means on June 20, 1979, the Treasury Department portrayed a picture of "widespread non-compliance" in the reporting of income, and the payment of income and social security taxes with respect to revenue received by independent contractors. The statement of Assistant Secretary of the Treasury Lubick alleged that ". . . at least 47 percent of workers treated as independent contractors did not report any compensation in question for income tax purposes. An even greater percentage, 62 percent, paid none of the social security tax due on their compensation."

Zero compliance in the trucking industry, according to the then Treasury study, was alleged to occur at the rate of 54.2 percent with respect to income tax, and 64.9 percent with respect to SECA taxes. Mr. Lubick also testified that "the IRS estimates that fewer than 60 percent of the required information returns for nonemployee compensation are actually filed."

The Treasury's testimony was based upon an Internal Revenue Service compliance study undertaken in the latter part of 1978 and early 1979. In our testimony before that Subcommittee we expressed substantial reservations about the validity of that study, not only in its results but in its methodology as well. Of significant concern to us was the fact that while the results purported to apply to all independent contractors, the sample from which the study was drawn consisted of those persons whom the Service had proposed to reclassify from independent contractors to employees.

While the number of individuals comprising each industry group was provided in the base data, it was not clear whether or not the individuals were properly classified in their industry category, or within subgroups within a particular industry. It should also be noted that those cases which did not contain enough information to provide what the Service considered a "reasonable possibility of follow-through" were dropped from the study.

While the implication was left with the reader of that report that the persons who could not be located deliberately failed to submit returns and pay their taxes, our view was that such inference was grossly unfair based upon the information provided in the study. For many years, the Service consistently refused to adopt a change of address form that taxpayers could submit to inform the Service of their change of location. The Service consistently uses the address on the tax return they are reviewing, which in most cases is two to three years old. In our mobile society, it is not at all unlikely, as the GAO pointed out in its July 11, 1979 report on "Who's Not Filing

Income Tax Returns?", GGD-79-69, that taxpayers have moved from one location to another within that time frame -- and moved for economic or family reasons -- not for the sinister purposes implied by the Service's compliance study. In this regard, we also note that the United States Postal authorities maintain the change of address forwarding service for only one year.

The Service's background data with respect to that study shows that 700 taxpayers comprised the "trucking" category of the study. But, only 396 of those taxpayers were "drivers" -- independent truck operators. Nevertheless, the Service's study indiscriminately implies that the alleged noncompliance percentages present a valid portrayal of the independent truck operator. We submit that this is simply not so.

It is also interesting to note that the background data, at one point, indicates that there was insufficient information with respect to 148 of the 700 taxpayers involved -- 21.1 percent of the trucking category. Yet, later data seems to indicate that 64 of those taxpayers were subsequently found to have previously filed returns, and 7 were found not to be required to file.

We note these matters simply to show that important questions about that compliance study exist. The GAO looked into some of these questions.

In mid 1981, the GAO sent to Congressman Rangle, in his capacity as Chairman, Subcommittee on Oversight, Committee on

Ways and Means, its report on its study entitled "Using the Exact Match File for Estimates and Characteristics of Persons Reporting And Not Reporting Social Security Self-Employment Earnings". This GAO report is identified as HRD-81-118, July 22, 1981.

Chart 1 of the study reports that 88.7% of truck drivers out of a universe of 190,000 truck drivers reported their SECA tax income. The study also noted that the 11.3% that did not report had an average SECA tax liability of $309. It should also be noted that Chart 3 of the study concludes that taxpayers having a self-employment earning of $50,000 and over have a 90+% SECA compliance level.

A taxpayer's SECA income and tax is reported and calculated on a Form SE, which is attached to, and made a part of, taxpayers income tax return, Form 1040. It would strain credulity to argue that a taxpayer would report his or her SECA tax liability, but fail to report income for income tax purposes.

We submit that the earlier Service compliance report is seriously, and fatally flawed, as shown by the recent GAO report.

In an attempt to determine the reporting activities of the payors in our industry, we did undertake to question some of our members. We sought this information from seventeen of our members from various gross income groups, who were geographically dispersed. While we do not claim that our survey was scientifically structured, nevertheless, we feel the results are illuminating.

Sixteen members responded, all of whom said that they filed Form 1099 with respect to payments to independent operators who had transported freight for them. It is also important to note that all of the respondents voluntarily provided copies of the 1099's to their payees, even before this requirement was enacted into law in 1981. In our opinion, this is a more accurate reflection of what our industry is doing than is the Service Compliance study.

We should note that in Table 1 attached to the Treasury Administration's written statement it was reported that where the independent contractor's amount of compensation (as corrected) was $50,000 and over the percentage of compensation reported for income tax compliance purposes was 98.4 percent, while the percentage of SECA tax paid was 66 percent. That table also noted that for that compensation level the percentage of payees with full income tax compliance was 92 percent, while compliance with some or all of the SECA tax was 66.7 percent.

We cite these figures since the survey we undertook, albeit unscientific, showed a profile of the independent operator as receiving compensation in excess of $50,000 per annum. In addition, one carrier, who contracts with approximately 800 independent operators during the course of a year, constructed a profile of the average operator. This demonstrated that the average annual amount of compensation received by the independent operator was $55,000.

The results of these studies supported our concern about the validity of the statements by the Treasury Department with respect to the alleged noncompliance by the independent operators of the trucking industry; our concerns have been validated, we submit, by the most recent GAC study.

WITHHOLDING TAX AND REPORTING

In its Report on The Regulatory Problems of the Independent Owner-Operator In The Nation's Trucking Industry (H. R. Rep. No. 85-1812, 95th Cong., 2d Sess., 1978) the Subcommittee On Special Small Business Problems of the Committee On Small Business concluded that the independent operator is a "vital segment of the motor carrier industry."

If this vital segment of our industry is unable to meet the very high fuel and other costs it faces, it will cease to exist, to the great detriment of the country. It is critical to note that what is at issue is not what the independent operator's margin of profit should be, but rather, and more importantly, whether the independent operators will be able to meet their increasing costs in order to survive in business.

The plight of the independent operator in meeting his costs was recognized by the Subcommittee on Special Small Business Problems which described it as a "continuing cost crunch . . . [resulting from such factors as] . . . the cost of equipment [which] alone has almost doubled in the past few years, and the cost of fuel [which] has in many cases more than tripled."

We believe that it is significant that the Subcommittee recognized the fuel problem in advance of the crisis with which the independent operators are presently confronted.

We estimate that on average, approximately 71 percent of an independent operator's gross receipts are consumed by fixed and operating expenses -- fuel, maintenance, finance costs, depreciation, insurance, tolls, permit and license fees and operating taxes. The profile developed by the carrier referred to earlier showed that the independent operator's average operating expenses totaled $39,000, resulting in his having remaining disposable income of $16,000. To these operating expenses the Treasury Department had proposed to add as an expense an additional 10 percent of the independent operator's gross revenues. To take a further 10 percent from an amount of compensation that is already squeezed in meeting fixed costs and operating costs that continue to escalate as a result of inflation would be unconscionable.

Clearly, the independent operator would not owe in taxes anywhere near the equivalent of 10 percent of his gross revenue. With an adjusted gross income of $16,000, we would estimate that exemptions and deductions would reduce the average independent operator's taxable income to approximately $10,000, which would result in a maximum income and self-employment tax of $1,875. This liability would be further reduced if the owner-operator created a Keogh Retirement Plan or an Individual Retirement Account.

Given the fact of high fuel and other costs that make it increasingly difficult, if not impossible, for independent operators to continue operating, the additional burden of a withholding tax would further reduce his disposable income and imperil the continued and viable existence of this vital segment of our industry.

We strongly object to any withholding proposal since the consequence will be the likely financial ruin of the independent operator.

While we strongly oppose the imposition of a withholding tax upon the revenues of the independent truck operators, we do not countenance taxpayers avoiding or evading their fair share of the tax burden imposed upon our citizenry. All must shoulder the financial burden of supporting our Government.

Consequently, we have recommended, and supported, substantial increases in the penalty for failure to file information returns, as well as any reasonable additional reporting that can be useful to the Service in its work to improve compliance levels.

The Treasury also urged at one time that the Congress consider correcting the disparity between the FICA and the SECA tax rates as a part of the broader issue of social security financing. We would not disagree with the suggestion for considering that matter. Nevertheless, the Treasury's allegation that ". . . independent contractors bear less than their fair share of the social security tax burden even when they report all of their income[.]" is, we submit, falacious.

The Treasury based its questionable conclusion upon the statement that:

> ". . . Although employees and independent contractors receive identical social security benefits, the social security taxes imposed on independent contractors under the Self-Employment Contributions Act (SECA) are lower than the social security taxes an employee must bear under the Federal Insurance Contribution Act (FICA). (Although one-half of the FICA tax is technically paid by the employer and one-half by the employee, in an economic sense the entire burden of this tax is borne by the employee.)"

The Treasury Department, regardless of Administration, has consistently failed to produce any empirical evidence to support the parenthetical sentence cited above.

Moreover, while it is true that the SECA tax imposed on the independent contractors is approximately seventy-five percent of the combined employer and employee FICA tax, the employer is entitled to claim a deduction under the general income tax rules for the FICA. The employer, of course, receives a tax deduction for the entire amount of compensation paid to the employee. We understand that the net effect of this tax treatment is that the total burden differential is substantially less than one percent.

LEGISLATIVE PROPOSAL
S. 2369

S. 2369 proposes alternative standards for determining who is, and who is not, an employee for employment tax purposes (Section 2); information reporting requirements for payments of remuneration for services (Section 3(a)); increased and new penalties for failure to comply with the information reporting requirements (Section 3(b)); and, effective dates for the proposals with transitional rules (Section 4).

We support the "safe harbor" test set forth in proposed section 3508(b) as being realistic, without being permissive of avoidance of tax obligations by individuals rendering service as truck owner-operators. The standards set forth take account of the historic independent contractor status of truck owner-operators. They meet the stringent tests that the Internal Revenue Service established for its audit manual guidelines - guidelines that the industry and the Internal Revenue Service have found to be supportive of the just claim of Government for its revenue, and understandable and administrable by both the industry and the Internal Revenue Service.

S. 2369 maintains the efficacy of the common law (Section 3508(d)), which we deem essential to any proposed legislation in this area. Furthermore, the bill is specific that its only area of impact is in the area of taxation (Section 3508(e)). This, we submit, is an essential provision.

We will submit to the Senate Finance Committee staff certain suggestions that we believe would clarify the statutory language proposed, as well as a recommendation with regard to coordination of the time for filing the notice of tax obligations with the notice of the amount of remuneration paid. These recommendations should not be deemed to represent a criticism of S. 2369, but rather suggestions that we believe would clarify and ease the burdens undertaken by the Government and the trucking industry.[*]

We submit that the trucking industry has in the past recognized its obligations with respect to reporting to the Internal Revenue Service. Therefore, we fully support the provisions of Section 3 of S. 2369 setting reporting requirements, and increasing the penalties applicable to the failure, without reasonable cause, of payors to meet their reporting obligations. We strongly support the provisions of proposed Section 6501(c)(8) establishing, in general, a six year statute of limitations on the assertion of penalties for failure to timely comply with the reporting obligations.

We believe that the effective date provisions of Section 4 of S. 2369 are reasonable, and generally provide our industry with adequate time to assure that we meet the requirements of the proposal.

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[*] The American Movers Conference will submit separately the changes they consider necessary.

CERTAIN PROCEDURAL RECOMMENDATIONS

In Senator Dole's statement accompanying the introduction of S. 2369 he noted:

> ". . . I am concerned about the procedural problems that may remain, even if this bill is passed, for certain businesses whose workers are not described in the safe harbor provisions. Accordingly, when this bill is considered in the Finance Committee, I would welcome comments . . . regarding procedural problems in the employment tax area and possible legislative responses."

We submit that Senator Dole's concern is well taken. The possibility will exist, even after the enactment of S. 2369, that taxpayers will be faced with massive assessments of tax liability even though they reasonably believed that those rendering services were independent contracts.

Under existing procedures, taxpayers in those cases must pay the full amount of the asserted tax, or pay some portion of the tax and provide a surety bond for the balance of the tax, before they can safely obtain a judicial review of the issue. The cost of the surety bond in many instances that we have heard of comes close to the amount of the unpaid asserted tax and is, therefore, of no help.

If the asserted tax is not paid or covered by a surety bond, the Internal Revenue Service continues collection activity, which in many instances results in the taxpayer being forced out of business.

We urge that the Congress consider the enactment of legislation that would:

1) authorize the concept of resolving the issue on the basis of a "divisible assessment" - that is an assessment with respect to one of the similarly situated persons rendering the service, for one quarter of the taxable year, without the requirement of a surety bond to cover the balance;
2) grant the United States Tax Court declaratory judgment jurisdiction in employment tax issues; and, or
3) grant the United States Tax Court general jurisdiction of asserted deficiencies in employment tax issues.

While these procedural enhancements are important, and we are certain that others will have additional worthwhile recommendations, the study of such proposals should not delay the most critical legislation - enactment of safe harbor rules before the expiration of the current moratorium on June 30, 1982.

We are prepared to work with the staff of the Finance Committee in refining or reviewing any procedural proposals, but again we must emphasize the need for the enactment of safe harbors before the end of the current moratorium.

TRUCKING INDUSTRY RECOMMENDATIONS

We seek to assure that the historical independent contractor status of the motor carrier industry's independent truck operator be preserved.

We strongly oppose any proposal for a withholding tax on payments made in the course of a trade or business to an independent contractor for the reasons already noted. Withholding proposals will not resolve the definition issue, and will not remedy the alleged compliance problem.

The issue of independent contractor or employee has been and should continue to be one of choice. It should be based upon the contractual agreement of the parties. What is at issue is the continued existence of the independent truck operator as a vital, viable and productive part of the motor carrier industry.

If an independent operator is unable to meet the test necessary to have the status of an independent contractor, it should be by choice. If an independent operator is unable to satisfy the test to qualify as an independent contractor, where historically he has been able to satisfy the test, it should be the exception rather than the rule. If an independent operator is unable to satisfactorily demonstrate compliance with the independent contractor test, it should not be because the test fails to take account of governmentally imposed burdens with which the regulated parties have no choice but to comply; where conflicting burdens do exist the test should recognize this. The enactment of legislation which fails to consciously address these general problems, applicable to any industry, will fail to preserve the historical status of independent businessmen, and to eliminate confusion, hardship and inequitable treatment.

We recommend the enactment of S. 2369, with suggested changes. We restate our position that Congress must enact safe harbor criteria whose application is not such that bona fide independent contractors might not be able to satisfy the strict requirements of the bill.

We further urge, of course, that the common law rule be retained, even with the enactment of the safe harbor provisions, as S. 2369 provides.

Thank you.

Duncan McRae, Jr.

Senator **Grassley**. Mr. Golden.

STATEMENT OF G. ZAN GOLDEN, SENIOR VICE PRESIDENT, NORTH AMERICAN VAN LINES, ON BEHALF OF THE AMERICAN MOVERS CONFERENCE, WASHINGTON, D.C.

Mr. **Golden**. Thank you, Mr. Chairman. My name is Zan Golden. I'm senior vice president of North American Van Lines. I'm accompanied by Cliff Massa, counsel for the American Movers Conference Tax Policy Committee, and my written statement is submitted on behalf of that conference.

Senator **Grassley**. Is that the time? [Laughter.]

Mr. **Golden**. I want to emphasize, in addition to supporting the comments made by Mr. McRae on behalf of the ATA, one item regarding the proposal by Chairman Dole. His bill, S. 2369, provides a series of standards which generally reflect the common law and IRS guidelines on independent contractor status. However, AMC recommends an elaboration on the language for the income fluctuation test. This test requires that more than 90 percent of the remuneration must relate to services or other output exclusive of so-called piecework. We understand that the intention is to apply a commonsense definition or description under which piecework means work that is in the nature of manufacturing or assembling, work that produces uniform and tangible products, and work that is paid for on a unit basis.

However, because there is no explicit definition or descriptive language, we are concerned about the potential applicability of the term to what we call "accessorial services" in the moving job. These services consist of packing goods in containers, unpacking those goods, handling bulky articles such as boats, automobiles, and pianos and other items that do not lend themselves to being included in the overall tariff schedule based on distance, weight, or volume. Therefore, they are priced on a unit or hourly basis.

While the amount and content of such services vary from job to job, they are an integral part of transporting a household shipment from one location to another.

In my written statement I note some statistical industry studies which indicate that in many situations such activities can account for more than the 10 percent leeway that is allowed in the income fluctuation test. Therefore, it is particularly important to the household movers, and particularly to the smaller carriers and their independent contractors who will generally perform more of such services, that the meaning of piecework not be misinterpreted subsequently to include anything other than the commonsense definition.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF G. ZAN GOLDEN
ON BEHALF OF
THE AMERICAN MOVERS CONFERENCE
"Independent Contractor Legislation"

April 26, 1982

My name is G. Zan Golden. I am Senior Vice President of North American Van Lines, Inc. My statement is submitted for the Subcommittee's hearing record on behalf of the American Movers Conference (AMC) in my capacity as a member of its Executive Committee and chairman of its Tax Policy Committee. The AMC represents approximately 1,000 member firms whose underlying network of some 5,000 movers and 25,000 independent truck operators provide more than 90% of this country's interstate household goods moving services.

The AMC is a member of the American Trucking Associations (ATA), and we share the general policy views and recommendations of the ATA as submitted to the Subcommittee in the written statement of Duncan McRae, Jr. Our statement is submitted to elaborate on the unique circumstances of the household goods moving industry as they relate to the issue of independent contractor status and to recommend specific changes in addition to those in the ATA statement.

The Household Goods Moving Industry

The household goods moving industry has a long history as a breeding ground for small independent businesses. In fact, our industry remains one composed almost entirely of small firms that are effectively linked together through both small and large van lines to provide the most efficient use of resources to serve the consuming public.

In earlier days when our society was less mobile and a typical long distance move might only have been into the next county, our industry was composed of a number of small motor carrier companies that undertook short distance moving. The local mover would transport a family's belongings across town or into the next county or perhaps to a large city. But the long distance move was infrequent. To the extent that cross-country moves took place, they were handled by the railroads in "pool cars" or as "immigrant moveables."

After World War I had shown more of the country to those in the Armed Services, and as the economy's labor force became increasingly mobile, the moving industry began to undergo a profound change. While the local move remains a significant part of the business, the long distance interstate move became more and more important. This gave rise in the late 1920's and early 1930's to the "backhaul bureau" which sought to link a local mover with a network that could efficiently allow him to move one family a great distance one way while improving his prospects of getting another load when he was ready to return home, even consolidating two or more loads on the same van. This restrained the cost of long distance moving by reducing or eliminating the mover's risk of "deadheading" or driving home with either a partially filled or an empty truck. By 1935, when the moving industry was brought under regulation by the Interstate Commerce Commission (ICC), these bureaus were already emerging as the modern van lines.

Currently, there are approximately 3,000 household goods carriers certificated by the ICC, and perhaps 98% are small businesses under the Small Business Administration regulations. There are approximately 8,000 local community movers located throughout the United States. Most of these movers are tied together by a contract with a van line or carrier possessing broad interstate authority. Nearly all of these 8,000 are small businesses. When they contract with van lines, they are known as agents and provide local services for the certificated carrier, such as packing, unpacking, and in-transit warehousing. Additionally, some of these local community movers have interstate authority for a region of the country. As a result, community movers may have a certificate to move household goods either under their own authority or as an agent for a van line. Finally, small van lines will interline with one another so that the independent truck operator will be transporting household goods under the certificate of two or more van lines.

Thus, the primary function of large and small van lines was originally, and still remains, to tie together a network of small movers who live in, and operate from, all areas of the country. It is through the coordination of thousands of small independent operators that our industry provides services to the American public.

It is noteworthy that some years ago when the ICC was the recognized model for solving economic regulatory problems, it appraised the moving system structure in depth, recognized that it is a creature of free enterprise, not regulation, and found it to be an efficient and effective apparatus to accomplish its purposes. The Commission then recommended to the Congress that it be relieved of certain of its policing functions relative to the structure of the industry, functions it declined to exercise in any event.

The Contract Operator

In line with this philosophy and in recognition of factors such as the interrelated character of the local, intrastate, and interstate elements of the moving industry, the highly seasonal nature of the traffic, and the historical method of augmenting equipment with the use of independent contractor truckers and agent lease equipment, the ICC has from the beginning shaped its leasing rules to accomodate the provision of adequate service by this broad-based and intricate system of transportation.

The van line may make a long-term lease (cancellable on a minimum of 30 days' notice to accord with ICC rules) with an independent contract trucker. Generally, although not necessarily, the van line provides the specialized trailer equipment. On the other hand, the van line agent may contract with the independent driver, provide the specialized equipment, and lease the entire rig to the van line on a long-term basis. In both instances, the equipment becomes a part of the carrier's permanent fleet. Additionally, the agent may contract with the independent trucker for service in its local or regional operations and may lease the entire rig to its principal carrier on a trip or intermittent basis. Again, this is all in accord with the Commission's specialized leasing rules for household movers. With the flexibility thus provided, we may have as many as 30,000 independent contract operators transporting household goods interstate during the three peak summer months when 50% of the traffic moves. The basic contract cost to the van line for thus augmenting its fleet generally ranges from 50% to 70% of linehaul revenue, depending upon the amount of equipment provided in individual cases and whether on a long-term or intermittent basis.

Additional charges, or a portion thereof, for "accessorial" services, such as packing and unpacking containers, are passed to the performing agent or the truck operator. Charges for packing and unpacking are priced and charged on a piece or container basis, per ICC regulation. Other accessorial charges may be priced on an hourly, weight, distance or item basis. Accessorial charges may, for some shipments, constitute almost half of the total moving charges. The individual contract operator's compensation amounts may vary substantially depending upon his participation in these activities, and it may vary by shipment or over an extended period of time. Moreover, since the independent operator in the moving business is free to turn down, as well as to accept, a shipment offered by the van line, compensation may further fluctuate via telephone negotiation when services are needed to pick up or deliver shipments in more remote areas of the country, in situations where carrier scheduling has become a problem due to weather or mechanical breakdowns, or in other instances of potential diminished profitability.

Normally, however, when the compensation package is agreed to and the pickup and delivery dates are fixed, the operator is essentially on his own. Subject only to Department of Transportation safety regulations regarding hours of driving and rest, and ICC regulations relative to pickup and delivery and other customer matters, the contract operator earns a profit on a shipment determined by how efficiently, skillfully and carefully he or she handles the goods. The expenses are the contractor's responsibility. Fuel, maintenance, tolls, meals, lodging, local labor, insurance -- all are costs that reduce the contractor's profit. Likewise, the purchase or rental cost of the tractor (and possibly the trailer and accessory equipment) are the contractor's to bear. Thus, both fixed and variable costs are economic facts that provide the contract operator with the incentive to make the most efficient use of his time and equipment.

In addition to the purely financial considerations, the contract operator in the household goods moving industry faces still another significant factor in his business -- the relationships with people. While drivers for our colleagues in the freight hauling sectors generally deal with other business entities from their loading docks, the household goods contractor deals directly with the consuming public, and most do so in the consumer's most private area -- the home. Uprooting a family and moving the goods in a household is a responsibility that weighs heavily on the contract operator. Not only must the contractor exercise great care in the loading, transporting and unloading (because he or she is generally responsible for all or some portion of any damages) but the contractor strives to provide courteous and thoughtful service because that performance reflects well or ill on the affiliated van line. Indeed, the contract operator's outstanding reputation for quality performance may generate specific requests for his or her particular services.

The most proficient of the household van operators, moreover, may not deal with the householder at all but rather with the curators of art museums, directors of trade shows and exhibits, or traffic managers for companies that manufacture computers, missile nosecones, or other high technology equipment where shipments are valued in the millions of dollars. Extensive security measures are often involved. Such operators may realize gross annual incomes of more than $150,000. The equipment required to produce that revenue is a well-maintained single-axle tractor. A twin-screw tractor normally is the equipment used in common freight hauling, but it will produce substantially less revenue for the freight operator than even a smaller tractor will accomplish for the household goods operator. Despite some contrast in the worth of the asset, it is indisputably essential in both instances to accomplish the task undertaken.

Finally, the household goods contract operator, due to his or her extensive and demanding duties beyond the tailgate, must deal with more demanding regulations and paperwork than any other operator in the motor carrier industry. Since this was a subject of intensive study and separate legislation in the 96th Congress (Household Goods Transportation Act of 1980), we will not elaborate here.

In summary , the contract operators in the household goods moving industry are mobile versions of the small, independent businesses that are found in every community around the country. The operator determines his or her own work habits (subject to major regulatory restraints and shipper requirements), negotiates the price for his or her services, covers expenses from revenues, determines his or her own efficiency and productivity, and deals directly with the consuming public. Thus, while van lines are able to weave together the essential national networks, it is the small contract operator that truly provides the basic service, and in so doing, manages his or her own business in a highly skilled and demanding profession.

Independent Contractor Legislation

As noted in the ATA statement submitted for the record, contract operators in the trucking industry in general have been recognized as independent contractors under both the common law and Internal Revenue Service administrative practices. While we were disturbed somewhat by indications in the 1970's that IRS might change its practices, it did not. Because the contract truck operator has for so long been clearly seen as an independent contractor by the courts, we strongly believe that the IRS would not succeed in attempting to remake its basic guidelines or to change common law.

Congressional moratoria on changes in IRS policy have reinforced that status. However, Congressional consideration of various proposals to write statutory rules governing independent contractor status creates the possibility that clear common law treatment will be clouded by an inference that a new Code section expresses Congressional intent.

Our intense interest in the ongoing legislative controversy therefore is not to create new law but rather to preserve and protect a recognized system of independent contract truck operators, a proven structure that effectively and efficiently accomplishes a basic need in our society and in our economy. It was created out of free enterprise. Free enterprise would recreate it if it were not in place.

Legislative Proposals for Independent Contractor Standards

The American Movers Conference's position with regard to the numerous proposals for the enacting of statutory "safe harbor" provisions continues to be rooted in three principles.

- We firmly believe that common law and IRS procedures have correctly treated the contract operator of a truck as an independent contractor.
- During development of any legislation, we seek only to ensure that our contract operators maintain their longstanding status. We do not seek to expand or enhance that status.
- We believe that it is essential for any legislation to state explicitly that it does not affect common law treatment and to provide "safe harbor" standards that clearly include the contract operator.

Briefly summarized, our interest in, and our willingness to support, a statutory resolution of this matter is contingent upon the clear inclusion of our contract operators who historically have been correctly classified as independent contractors.

S. 2369

The proposal by Chairman Dole, S. 2369, provides a series of standards which generally reflect the common law and IRS guidelines. However, any "safe harbor" tests adopted must take account of the very specialized operating practices of the household goods trucking industry. Because some of the household goods industry's practices, particularly in the area of pricing for services, differ from those of the remainder of the trucking industry, we will focus on a primary concern in the proposed fluctuation of income standard and recommend appropriate clarification in the statutory language or accompanying Committee report. We will also raise for consideration other provisions on which further elaboration in the Committee report would ensure that they will be applied in a common sense manner.

Income Fluctuation

The risk of income fluctuation, like the control of hours, is a primary characteristic of the status of an independent contractor. For the contract truck operator, his decisions regarding which shipments to accept and his management of time and expenses will determine his net income for the year rather than simply the number of hours that he works.

While S. 2369 recognizes the significance of this factor by its inclusion of the test, a problem arises with the test as drafted due to the minimum amount--namely, more than 90%--that must relate to service output exclusive of "piecework." The problem is the absence of a definition of piecework or of a delineation of its application to individual moves, to a series of related services, or to any period of elapsed time. Our understanding is that "piecework" is intended to mean only work that is in the nature of manufacturing or assembling, that produces uniform and tangible products, and that is paid for on a unit basis. For the household goods mover, however, the potential uncertainty is of such significance that we strongly urge a statutory definition or at least an explicit Committee report discussion that excludes certain activities. Our concern results from both ICC regulation and industry practices under which the independent trucker performs, and shares in the remunerations from, various accessorial services which are priced on a unit or time basis.

These services, as the name implies, are accessory to any complete moving job. They are included in a job to varying degrees depending on the circumstances. They consist of packing goods into containers, unpacking those goods, performing extra pickups and deliveries, handling bulky articles such as boats, automobiles, snowmobiles, etc., piano handling, overtime loading and unloading, and extra labor services not otherwise specified but which may be requested by the customer. These services are priced by the piece, by the item, or on an hourly basis because they do not lend themselves to being included in an overall tariff schedule based on distance, weight, etc.

Based on industry studies for the three years 1978-1980, charges for such services in which truck operators might participate range from 12 to 14 percent of the carrier's interstate revenues for household moving. Charges for packing and unpacking alone run 9.05 percent to 10.05 percent. These are calculated separately because ICC regulations require that they be priced on an item basis, by size of the container. For our industry as a whole, the preponderence of these services are performed by agents rather than the truck operators. But such practices vary widely among carriers. There are instances in which individual contract operators on an annual basis, or for particular contract periods, do in fact receive compensation from these services that reach the 10 percent amount that fails to meet the "more than 90 percent" requirement in S. 2369. For example, in 1981 a low accessorial revenue-producing driver for North American received 5.4 percent of his compensation from this source of revenue, but on the high side another had 20.7 percent. It is probable, moreover, that any given truck operator will perform one or more moves involving substantial compensation of this type. Such is the nature of household moving.

Furthermore, the percentage factor and the schedule under which it may be priced can vary substantially not only because of the items included, but simply because the normal transportation ingredients of weight and distance vary dramatically from shipment to shipment.

Our understanding is that such services are not intended to be covered by the term "piecework." But, as is illustrated by the figures noted, this matter is of such potential significance to our industry that we urge that statutory language clearly state that "piecework" refers only to manufacturing or assembly or other production of uniform tangible items and not to service performance.

Additional Clarifications

There are two provisions of S. 2369 that the AMC believes need additional statutory clarification or at least should be discussed in the accompanying Committee report and legislative history. Both are matters in which a common sense application of the language would cause no problem, but we urge that you take steps to ensure that only such an application is possible.

Investment in assets. The alternative standard regarding investment in tangible assets should be applied to include the vehicle used by a household goods independent operator in performing his service. Our vehicles tend to be smaller and less expensive than those used by our colleagues in the freight hauling business. In addition, they may be older, and therefore less valuable and more fully or completed depreciated, than the freight-hauling truck/tractor. Nonetheless, the statute or Committee report should state clearly that the truck/tractor used in the moving of household goods is an asset that meets S. 2369's dual requirements, namely that it is "of significant value in the performance of the service" and that the investment in it "is a substantial economic investment in light of the nature and amount of remuneration received...."

Coordination. The control of hours standard has an accompanying special rule noting that the individual is not treated as not controlling any scheduling of hours worked merely as a result of "the coordination of the performance of the service with the performance of other services but only if such coordination is done by a person other than the service recipient or a related person." We would not expect the carrier's/dispatcher's development of multiple loads for one operator to be covered by the exclusionary clause for service recipient coordination, but clarification would be helpful.

Withholding

The AMC has strongly opposed a withholding tax on payments to independent contractors. As has been emphasized above, the contract truck operator is an independent small business owner. His net income subject to tax is a function of his appetite for shipments and his management of time, money and expenses. To impose a withholding tax on his distribution of revenues would impose a tax that probably bears little relationship to the final tax liability of the vast majority of operators. A 10% withholding tax on gross receipts could fully eliminate a contract operator's margin of profit. Even if some operators were not significantly overwithheld, the change in their cash flows under such a system could be substantial.

Along with ATA, AMC supports S. 2369's absence of general withholding. While we do not disagree with the limited withholding to be imposed when the parties fail to comply with their obligations, we strongly prefer that such payments be cast as penalties rather than as a withholding tax.

Summary

Any legislation enacted to provide safe harbor standards for independent contractor status should define those standards in such manner as to ensure that they are at least as broad as IRS guidelines and the common law. Furthermore, such legislation should explicitly state that it is not a replacement for common law determinations.

S. 2369, with changes regarding specific points discussed above, is a statutory proposal that can accomplish those objectives. However, the changes are particularly important to the contract operators who are household goods movers.

The AMC urges that the specific changes be taken into account when legislation is reported.

Senator GRASSLEY. Mr. Rolston.

STATEMENT OF K. S. ROLSTON, PRESIDENT, AMERICAN PULPWOOD ASSOCIATION, WASHINGTON, D.C.

Mr. ROLSTON. Thank you. I have with me my attorney, Colm McKeveny.

The American Pulpwood Association supports the safe harbor and compliance enhancement provisions of S. 2369. And in addition, we bring the support of a coalition of 51 other associations representing logging contractors and other segments of the forest industry located in 34 States.

This bill will preserve the traditional independent business relationships in the logging industry that were recognized in law and by the IRS prior to and during the time of the Service's redetermination efforts.

However, retention of the common law as an alternative is necessary because the provision provides for equitable determination with respect to individually negotiated logging industry agreements which don't qualify under the safe harbor.

On a number of occasions and again this afternoon, we seem to get the inference that the business relations out there in the woods are created for tax purposes. I can tell you that they aren't. They are created because people want to go into business for themselves, have their own business, and hopefully to build assets which they can pass on to their folks. These decisions are not based on tax purposes.

The provisions of the bill providing for increased penalties for noncompliance with existing information reporting requirements are just and we believe accurate reporting is the key to equitable and efficient tax administration. Certainly not withholding, which would create terrible cash-flow problems with our folks.

The previous IRS study said that independent contractors lead a high rate of noncompliance. We don't believe this has been proven. I don't believe a study composed of people already in trouble with the IRS is going to tell you that you have got a real problem out there. We would also refer to the GAO report of 1977, which certainly shows an entirely different situation.

It has also been inferred that the last thing that we would want to have happen is to have to go on with section 530 interim relief. For the logging industry, that just isn't so. Unfortunately, the experiences we went through included situations where corporations were considered by the IRS to be employees. Most logging contractors have employees, and you had employers being called employees. On top of that, most of our people out in the rural areas quite often don't have access to the legal assistance they need to get through these IRS attacks. We certainly prefer section 530 being extended over being subject to the IRS drive to create unintended employment relationships.

We know through communication with several IRS offices that the employment tax laws can be properly enforced. We believe they should be. On a number of occasions in Pennsylvania and north Florida, special investigations of our industry were made. Unfortunately, the IRS did not see fit to tell us too much about the results of this which leads us to believe that the compliance picture was good.

We are certain that in our industry education is the major ingredient in working toward full compliance. We have had a long and worthy record in this field. We pledge to continue to play an active role in informing all in our industry about their tax obligations. This is a commerical for our educational booklet, "How To Stay At Peace With Your Government." We believe in education and we want to try and help all of our folks to stay at peace with the Government.

S. 2369 is the solution to the real problem: independent contractor status. We will do our best to continue to help our industry stay at peace with its Government.

Thank you very much.

Senator **Grassley**. Thank you.

[The prepared statement follows:]

AMERICAN PULPWOOD ASSOCIATION

April 26, 1982

STATEMENT

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE SENATE COMMITTEE ON FINANCE

BY THE

AMERICAN PULPWOOD ASSOCIATION
1619 Massachusetts Ave. N.W.
Washington, DC 20036

ON

S. 2369

THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION
AND COMPLIANCE ACT OF 1982

Summary of Principal Points

- Logging contractors support the safe harbor and compliance-enhancement provisions of S. 2369, The Independent Contractor Tax Classification and Compliance Act of 1982.

- S. 2369 will preserve the traditional independent business relationships in the logging industry that were recognized in law and by the Internal Revenue Service prior to and during the time of the Service's redetermination effort.

- Retention of the common law as an alternative will provide for equitable determinations with respect to the individually negotiated logging industry agreements which do not qualify under S. 2369's safe harbors.

- The provisions of S. 2369 providing for increased penalties for non-compliance with existing information reporting requirements are just and we believe accurate reporting is the key to equitable and efficient tax administration.

- We reaffirm our belief that the vast majority of logging businessmen are in compliance with the tax laws, as reflected in the GAO Report to the Joint Committee on Taxation, Tax Treatment of Employees and Self-Employed Persons, November 21, 1977 (GGD-77-99).

- We urge affirmative action on S. 2369 now, and failing that, that Sec. 530 be extended. We prefer substantive relief - but greatly fear being again subject to improper IRS enforcement.

- We know through communication with various IRS offices that the employment tax laws can be properly enforced, and we believe they should be.

- We are certain that in our industry education is the major ingredient in working toward full compliance. APA has a long and worthy record in this field, and we pledge to continue to play an active role in informing all in our industry about their tax obligations.

- S. 2369 is the solution to the real problem: independent contractor status. We support measures to improve reporting. We will do our best to continue to help our industry stay at peace with its government.

Introduction

I am Ken Rolston, President of the American Pulpwood Association (APA). APA represents both producers and consumers of pulpwood in the United States. Pulpwood is the essential raw material used in the manufacture of pulp and paper products, one of the nation's largest and most productive industries. Our membership includes not only those businessmen and firms that the Internal Revenue Service (IRS) in past years has alleged are new "employers," but also the businessmen and firms that were unwillingly reclassified by the IRS as "employees."

APA's members are vitally interested in the legislative proposal being considered here today. An important part of APA's membership is the independent small businessman managing, operating, and heavily investing in forestry equipment and machinery. Many of these capital-intensive businessmen, the vast majority of whom have employees of their own, found themselves "stripped" of their status as independent businessmen because of the enforcement policies of the IRS. Although the dollar effect of assessments frequently rested upon one of the purchasers of their products or services, the effect of each assessment was no less devastating to the logging contractor. Access to capital sources diminished when financial institutions had knowledge that a governmental agency was challenging their status as independent businessmen. Carefully planned retirement programs were suddenly open to challenge. Agreements with other purchasers and access to other forest products markets were jeopardized. There was a natural tendency by purchasers not to do business or to continue to do business with logging contractors allegedly "employed" by another purchaser, especially in those circumstances in which the purchasers were competitors.

The foregoing should bring into focus the central issue that must be properly addressed: Who is an independent contractor for tax purposes? Businessmen, both buyers and sellers, cannot operate in a situation similar to that of Damocles, the courtier of ancient Syracuse who reportedly was seated at a royal banquet beneath a sword suspended by a single hair.

Our Position

We fully support the legislation introduced by Senator Dole, S. 2369. We believe it is in the best interests of this nation that the legitimate, longstanding, and traditional business relationships existing in the logging industry be maintained and enhanced. We aver that S. 2369 is an equitable means to accomplish that objective. The following 51 organizations, which represent logging contractors and other forestry and forest industry interests in at least 34 states, join with APA in support of S. 2369.

Alabama Forestry Association
Alaska Loggers Association
Appalachian Hardwood Manufacturers Association
Arkansas Forestry Association
Associated California Loggers Inc.
Associated Logging Contractors Inc.
Associated Oregon Loggers

California Forest Protective Association
Connecticut Wood Producers Association
Empire State Forest Products Association
Florida Forestry Association
Forest Farmers Association
Georgia Forestry Association
Kentucky Forest Industries Association
Louisiana Forestry Association
Maine Forest Products Council
Maryland Forest Association
Massachusetts Wood Producers Association
Michigan Association of Timbermen
Minnesota Timber Producers Association
Mississippi Forestry Association
Missouri Forest Products Association
Montana Logging Association
Montana Wood Products Association
New Hampshire Timberland Owners Association
North Carolina Forestry Association
Northeastern Loggers Association
Northeastern Lumber Manufacturers Association, Inc.
Northern Hardwood & Pine Manufacturers Association
Northern Woods Logging Association
Ohio Forestry Association
Oklahoma Forestry Association
Oregon Log Truckers Association
Pennsylvania Forestry Association
Rhode Island Wood Operators Association
South Carolina Forestry Association
Southeastern Lumber Manufacturers Association
Southern Forest Institute
Southern Forest Products Association
Southern Hardwood Lumber Manufacturers Association
Southern Oregon Timber Industries Association
Tennessee Forestry Association
Texas Forestry Association
Timber Operations Council
Timber Producers Association of Michigan & Wisconsin
Vermont Timber Truckers and Producers Association
Virginia Forestry Association
Washington Contract Loggers Association
Washington Log Truckers Conference
West Virginia Forests Inc.
Wisconsin Paper Council

Support for the Common Law and the Need for a Proper Legislative Solution

A major part of our support for S. 2369 is based upon the fact that it does not supplant the traditional common law test. It is possible that the negotiated terms of some independent contractor relationships in our industry will not meet all of S. 2369's requirements - yet, in the real world, the relationship will be truly independent when the totality of the relationship is judged under the common law rule. With this important point in mind, it is useful to review the history of employment status determinations for federal tax purposes because it demonstrates why we are here today and why a proper legislative solution is imperative.

The Tax Code, as originally passed by Congress, left the employee/independent contractor issue vague. In a number of decisions the Supreme Court stated that a new doctrine, the "doctrine of economic reality" was the test Congress intended be used to determine employment tax obligations. This determination seriously threatened traditional contractor relationships.

In 1948, Congress explicitly rejected the Supreme Court's "economic reality" interpretation, thereby preventing the adoption of IRS regulations that could have converted independent businessmen doing a significant volume of business with one firm into that firm's employees. (Gearhart Resolution, H.J. Res. 296, P.L. 642, 80th Cong., 2d. Sess., Ch. 468, 62 Stat. 438 (1948); 2 U.S. Code Cong. Serv. 2501, 2501 (1948).) The rejection was the result of two concerns: first, overexpansion of the Social Security system and second, having a contractor's status rest on an "unworkably vague" definition. The Congressional wisdom, to avoid an "unworkably vague" definition, remains as astute today as it was in 1948.

From 1948 until Section 530 "interim relief" was enacted in 1978, the IRS applied its test of who is an employee with strong economic reality bias - in effect, rejecting the Congressional mandate. This deliberate rejection of a Congressional mandate has been the primary reason for the constant controversy in this area. The result has been chaos. IRS' continued repudiation of Congress' enacted view is the main reason for the constant and unnecessary controversy and tension. The problem was not the common law test of employee/independent contractor. The problem was the refusal of the Executive Branch to accept the mandate of the Legislative Branch. The common law continues to have meaningful application to today's question and tax issues generally. We would not support any legislation that would replace the common law as the appropriate test for determining employment tax obligations.

The common law test is flexible. We recognize that this flexibility may produce a slightly irregular pattern as new and novel business relationships arise. It is precisely that flexibility, however, which permits the common law test to judge meaningfully and predictably the nature of the relationship between parties in new and novel economic situations. An additional attribute of the common law test, that is not merely desirable but essential in most tax matters, is its neutrality. In a dynamic, free-enterprise economy it would be tragic to have the tax code impair or interfere with the decision-making process between and among business parties.

IRS Enforcement

Employment tax cases can not be brought in Tax Court. Therefore the taxpayer must pay the assessment or an agreed percentage of it in advance and bring suit for a refund. Actual assessments contained not only the "usual" assessment penalties, interest, uncollected withholding, social security, and unemployment taxes, but also disallowed contributions to otherwise qualified pension plans and challenged individual retirement programs. Essentially, assessments could and did exceed the capitalization of taxpayers large and small alike. This, coupled with the intransigence on the part of the IRS in allowing a taxpayer access to court without paying the entire assessment or purchasing a bond for the entire assessment (a radical departure from previous policy), essentially forced individuals and firms either to go out of business by administrative fiat with no judicial recourse or to simply succumb to the IRS view.

Note should also be made that IRS enforcement actions were predominantly undertaken in instances in which virtually all prior judicial precedents and revenue rulings uniformly held that the individuals, suddenly alleged to be employees, were independent contractors.

Prior Congressional Action

Congress remedied the situation temporarily by enactment of Section 530 of the Revenue Act of 1978 (P.L. 95-600). This relief was subsequently extended twice (P.L. 96-167 and P.L. 96-541) and expires June 30, 1982.

In 1979 in the 96th Congress, Senator Dole introduced S. 736, which was similar to S. 2369 now being addressed. No action was taken. In the House in 1979, Representative

Gephardt introduced H.R. 3245, similar to S. 736, substantive legislation designed to solve the real problem: who is or is not an independent contractor. Representative Gephardt's realistic solution was rejected.

A substantive solution is now imperative.

The Merits of S. 2369

S. 2369, introduced by Senator Dole and co-sponsored by Senators Danforth, Boren, Roth, Johnston, Kassenbaum, Laxalt, Durenberger, Symms, and Wallop, is a positive and realistic long-term solution to what was misdirected and unmerited IRS enforcement activity, that resulted in unnecessary, vexing, and troublesome problems for many years before the enactment of Section 530. S. 2369 clarifies for logging businessmen and for the IRS, on a meaningful and substantive basis, who is or is not an independent contractor. As a result, it clarifies tax obligations, provides for predictable and equitable enforcement of all the tax laws, and does not disrupt decades of tax status development. Ultimately, S. 2369 will curtail the unnecessary expenditure of funds to resolve status disputes, improve reporting, and most importantly, enhance voluntary compliance with respect to tax obligations.

We also support this legislation because it does not supplant the traditional common law tests of independent contractor status. As a matter of fact, we could not support legislation which would substitute safe harbor tests for common law definitions.

Prior to the enactment of Section 530, IRS enforcement reflected an unauthorized and unilateral revision of the definition of and distinctions between an "employee" and an "independent contractor." APA members voiced serious concern with the employment tax audits and assessments affecting them. This concern required in-depth research of the common law "right to control" test, the proper statutory basis for determining employment tax obligations. We exhaustively analyzed the 20 criteria used by the IRS as theoretically indicative of the right to control. From this research and analysis we have concluded that the tests enumerated in S. 2369 are the most meaningful criteria that could have been chosen.

The first three tests of S. 2369 state the factual situations in a business relationship that must exist before an independent contractor and a payor are recognized as separate, viable, independent business entities. The tests are tough, and embody the essence of being an independent businessman. The basic questions are, and always have been, "Do you, Mr. Businessman, run your own show?" and "Are you, Mr. Businessman, subject to the risks of the marketplace?" and "Mr. Businessman, if you require and are using a principal place of business, are you paying for it?" Because S. 2369's criteria embody the essence of what it means to be a proprietor of a business, we consider it impossible for any self-employed businessman to simultaneously fulfill S. 2369's substantive requirements and yet be an employee under the common law rule. The criteria, therefore, are not subject to manipulation or abuse.

A further significant benefit of S. 2369 is enhanced tax compliance. It is axiomatic that before any individual can comply with tax obligations, he must have some reasonable basis for determining the nature of those obligations. S. 2369's first three criteria provide a clear and predictable mechanism for determining status in a business relationship - and therefore knowing one's tax obligations. Control of hours worked and of the scheduling of those hours, principal place of business, if any, and risk of income fluctuation or, alternatively, substantial investment in tangible assets, in addition to being truly indicative of owning a business, can be readily determined. They provide an intelligent and predictable basis for decision.

Tax compliance is further enhanced through the remaining two safe harbor requirements and the new graduated penalties for inaccurate information reporting. The S. 2369 requirements of a written agreement delineating the actual relationship between the parties along with their corresponding tax obligations and complete compliance with existing IRS regulations concerning information returns are an affirmative action tax plan. Taken together, these provisions alone will enhance voluntary compliance and ease enforcement problems. When further supplemented with the provisions designed to improve and assure greater accuracy in information reporting, enhanced compliance is virtually assured.

In summary, S. 2369 answers what has been and must be recognized as the fundamental question: who is or is not an independent contractor? It answers that question on a basis that is not only consistent with business realities but also consistent with equitable enforcement of and improved voluntary compliance with tax obligations. Further, S. 2369's safe harbor will enable the IRS to guide its enforcement efforts to the correct port -- the properly identified non-complying taxpayer. The senseless drift of those resources and their utilization in protracted, unwarranted, unnecessary, and unproductive litigation to simply identify the taxpayer (properly a legislative matter) will finally end.

We support the provisions of S. 2369 which develop a new penalty system aimed at improving the accuracy of information reporting on payments to independent contractors by service recipients. We have been advising our members of the benefits to them and to the government of strict compliance with Sec. 6041A for many years. Providing accurate data to the IRS concerning the identification of taxpayers and the amounts paid coupled with matching of payments with returns will provide the most effective and efficient means to stimulate improved compliance.

Procedural Issues

S. 2369 will not solve all of the problems associated with IRS employment tax audits. It will solve the major problems which our industry has encountered in the past by preserving the status of most traditional relationships that heretofore were recognized by the courts and the IRS as independent.

For those relationships in logging which will have to rely on the common law tests, the difficulties associated with retroactive assessment and access to the courts remain. The question of retroactivity should be reexamined in instances in which service recipients have properly filed information returns. We also feel that these cases should have access to the Tax Court.

However, we do not recommend that these procedural issues be addressed now. The time is short for enactment of S. 2369. Remaining issues can be addressed at a later date, when and if they become problems.

No Return to Past Practices

Section 530 ended a nightmare for many in our industry faced with mounting legal expenses and, in some cases, difficulty in obtaining capital financing because of undecided status. If Section 530 were permitted to lapse without enactment of the long term solution represented by S. 2369, we are certain that the IRS would resume its improper enforcement activity and return to its previous misapplication of the economic reality test. That must not be permitted. It is appropriate to read the text of a radio broadcast concerning an APA member who has appeared before Congress on this issue. The broadcast is entitled "Independents vs. IRS," and was delivered February 23, 1978 by the man who is now our President, Ronald Reagan.

> Reginald Dwyer is one of a rare breed, an independent Vermont logger. Even in subzero weather you can find Reg Dwyer out in the woods, bringing out pulpwood to feed the nation's huge appetite for paper products. And, after a hard day in the woods, you may find him at the school board meeting in his little town of Sheffield. Reg is one of those dependable, community-minded small businessmen who have done so much, over two centuries, to create the image of Vermont in the national mind.
>
> But Reg Dwyer is in trouble - $18,500 worth of trouble - with the Internal Revenue Service. It's not about paying his taxes - he's always done that. It's about paying other people's taxes. To understand why the IRS is hounding him and dozens of other small logging contractors in New England and the deep South, it's necessary to know how an independent logging operation works.
>
> Most of the pulpwood produced by independent loggers in the Northeast is produced on what is called the contract system. The prime contractor - a man like Reg Dwyer - secures stumpage or cutting rights. Then four operations follow in sequence: felling and limbing the trees, skidding the logs to a collection yard, cutting the logs to pulpwood size, and loading and trucking the wood to the paper mill. Sometimes, in large operations, one company will hire employees to perform these various operations. But, in independent logging, each operation may be performed by a specialist who works on contract with the prime contractor. Fellers and cutters provide their own chain saws, fuel, safety equipment, and transportation to the job. The skidder may own his own bulldozer or skidder to haul the logs out of the woods. The trucker will own his own truck with an expensive clamshell loader.
>
> Now, all these subcontractors are in business for themselves. They may work for many different logging contractors over the year. But the IRS has traditionally been hostile to this independent business system because it makes it more difficult for it to track down and tax every dollar of income. Self-employed persons pay less than employees to social security. And they may deduct up to five times as much in self-employed retirement plans as employees.
>
> So the IRS informed the Dwyers - by announcing it to them before their neighbors in the lobby of the Sheffield post office - that they owe Uncle

Sam $18,500 in social security, withholding, unemployment insurance taxes, penalties and interest for all the independent subcontractors they have contracted with over the past five years--whether or not those subcontractors have already paid the required taxes! And if the Dwyers have to pay, it will darn near put them out of business.

New England's independent loggers are not the only victims of this IRS attack. Independent contractors of all kinds--artisans, truckers, taxicab operators, repairmen, and fishermen are under the same gun (although Congress exempted certain lobstermen by statute in 1976). It's time that Congress told the IRS loud and clear, that the independent small contractor is a vital part of America. They cannot survive if, in addition to the risks of the economy, they are harassed into insolvency by an IRS determined to make them pay the taxes of others with whom they contract, as well as their own.

APA's Traditional Concern for Tax Compliance

The reputations of many independent contractors have been unnecessarily and wrongfully sullied because of IRS assessments and allegations. In a reputable study concerning contractor compliance (General Accounting Office, Tax Treatment of Employees and Self-Employed Persons, November 21, 1977, GGD-77-99), the GAO concluded that "those taxpayers involved in employee/self-employed redeterminations had generally paid their income and social security taxes" (p. 24). This finding was predicated upon IRS data from the Taxpayer Compliance Measurement Program which indicated that independent contractors reported 96.7% of their gross receipts.

APA believes it is partly responsible for this excellent record and further believes that it can be improved upon. We also know that the employment tax laws can be enforced. We know that independent contractors can be found, their tax obligations determined, appropriate action taken, and the level of voluntary compliance enhanced if the correct problem is addressed and the correct solution applied.

A letter from an IRS office suggests a way APA could assist IRS in its mission of achieving voluntary compliance:

> (Develop) a continuing education program to make pulpwooders fully aware of their federal tax obligations, both business and personal.

APA has a long and continuing record of tax law compliance education dating back to the mid-1960s. Most recently, over a two year period (1976-1977), in cooperation with the

IRS and the Social Security Administration, APA carried out an extensive information and education program, including the production of two films, to help logging businessmen know their proper tax obligations. The effort involved hundreds of meetings on a virtually county-by-county basis in numerous forested states, and reached over 20,000 people. We know this joint effort generated a greatly improved understanding of complex tax law requirements and improved the level of compliance.

Our education efforts continue both at the field level and through distribution of our landmark 145-page publication, How to Stay at Peace With Your Government, which has been through six revisions and has been broadened to include vital information on all federal laws and general information on state laws affecting employers. We intend to continue these educational efforts.

We firmly believe that small logger businessmen want to fulfill their obligations to government and that they will do so if they know what is required.

The Original Compliance Study and the IRS Withholding Proposal

We began our comments concerning tax compliance by noting that the reputations of many independent contractors have been unnecessarily and wrongfully sullied. An action that contributed significantly to the notion that law-abiding independent contractors were not meeting their tax obligations was the Treasury Department Study concerning tax compliance presented at the July 16, 1979 hearings of the House Subcommittee on Select Revenue Measures. The study concluded with the proposal that withholding be instituted on payments to independent contractors. That study has been repeatedly referred to by IRS officials as indicative of the problem to be solved. Although the study was never officially presented to the Senate Subcommittee on Oversight, we wish to relay expert observations concerning it. We believe that after analysis this subcommittee will share the conclusion that all impartial observers have made: The study is tragically flawed and does not prove that which it purports to prove, its conclusions are totally contradicted by independent governmental studies in which an agency did not have an "axe to grind," and at minimum, the study should not be used as the basis for any substantive policy action. We will stress here the findings as they relate to the timber industry. The following analysis is necessarily lengthy and technical. However, because the study appears to remain a basis for IRS proposals, we consider the analysis necessary to dispel the misconception of sizeable noncompliance by independent contractors.

The "Logging and Timber" category included 75 employers, resulting in 146 workers whom the IRS reclassified from independent contractor status to employee status. (Basic Tables, Vol. I, Table 2.) This employer group of 75 represents only .09% of the tax returns filed by sole proprietorships during the fiscal year ending June 30, 1976, and .116% of the returns filed by partnerships in that same year; the remaining 13 employers come within the corporate category. (Statistics of Income, 1975, Bus. Inc. Tax Returns, Sole Proprietorships, Partnerships, Dept. of Treas., IRS Pub. 438 (July, 1978).) The employers chosen were not representative; they were simply those employers with tax disagreements with the IRS at the time of the study. The study's procedures were similarly geared to convenience rather than accuracy.

The following study procedure was outlined by Treasury during a phone conversation on July 12, 1979: All open examination cases involving the employee/independent contractor issue - totalling some 6,000 cases - were pulled in from the field offices. Of the 6,000 cases, approximately 2,600 were selected as being "useful." Cases considered not useful included those with incomplete data, incomplete audit information, or employer records lacking useful lists of workers. From the 2,600 "useful" cases, 50,000 to 60,000 names of workers were found. Out of these names, the study targeted on 5,000 to 7,000 worker names, the goal being 300 to 400 worker names in each industry group (there were only 105 workers used in logging and timber). Rather than setting the size of the sample by the number statistically mandated to produce a valid and representative sample, Treasury allowed the sample size to be determined by budget limitations and time deadlines.

This study procedure meant that not even the scant 146 workers in the "Logging and Timber" category would all be used in the study - only the "useful" ones would be used. At the outset, 33 workers were viewed as "useful." The remaining 113 were sent for investigation to determine their usefulness. Those who had filed a return were considered "useful," as were those who were delinquent in filing a return and those who simply refused to file. Workers who could not be located (26) or, albeit located, could not be contacted (2) were viewed as not useful. Even more amazing was the elimination of the 13 workers who were found at the outset to be not liable - that is, in compliance. All in all, 28.08% of the tiny group of 146 workers were eliminated from the study as not "useful." (Basic Tables, Vol. I, Table 3.) This resulted in use of the following returns of workers (Basic Tables, Vol. 2, Table 4; Vol. 4, Table 5):

Initial Selection	33
Delinquent Return	10
Previously Filed	50
Refusal to File	12
Total	105

Treasury justifies its elimination of 41 workers from the study by assuming those workers would all be noncompliers in any event. (Lubick, Statement before Subcommittee on Select Revenue Measures, June 20, 1979, p. A-5.) The 13 found to be not liable certainly do not fall in this category.

Of the 105 returns used, 72 are for calendar year 1976 and 33 are for calendar year 1977. (Format A Tables, Vol. I, Table 2, p. 50.) If each return, regardless of year, represents a different worker, then one wonders why the IRS did not check the other year as well, since the study purports to cover both years. Using the IRS rationale, that the smaller and less frequent the payments the more likely noncompliance, it is likely that those in full compliance would be in full compliance for both years and many of those in noncompliance would not show up at all in the other year. On the other hand, if the 33 returns falling in calendar year 1977 belong to workers who are also included in the 72 returns for 1976, then the sample used for logging and timber becomes drastically tinier and even less reliable than it is already.

An even more disturbing aspect to this study is the fact that slightly more than 16% of the determinations made by the IRS to arrive at the 105 returns used in the study were performed without either a specific identification or the use of one of the IRS' customary indirect methods. Rather, the determination was made some "other" way. (Format A Tables, Vol. I, Table 2, p. 52.) It is difficult to imagine why the IRS would have to stray from its usual investigation and determination methods if accuracy were considered important.

It seems clear from the Format A Tables, Volume II, that the IRS was only able to reach 98 out of the 105 workers in any event. Moreover, 12 of the 105 (presumably the refusals to file) have disputes with the IRS other than the independent contractor/employee issue. (Format A Tables, Vol. I, Table 2, p. 59.) Nevertheless, if one accepts every single assumption made by Treasury, except for the assumption that the 41 eliminated people are all tax evaders, the noncompliance rate determined by the IRS changes greatly.

The IRS' own dollar figures set forth in the study bear out this likelihood. The logging and timber category shows $15,500 in income tax on unreported wages as determined by the IRS. (Format A Tables, Vol. I, Table 2, p. 58.) Twenty-nine of the 105 returns fall in the zero tax percentage bracket. That is, when the tax percentages were applied to the corrected wages, as viewed by the IRS, the tax rate was zero. In addition, the IRS has set forth a zero divisor category encompassing 25 of the 105 returns. Zero divisor represents the elimination of those returns upon which it was not possible to acquire any tax bracket because of the low level of taxable income applicable to that return. While it is not clear why the two groups have been divided between the zero divisor group and the zero percentage group, nevertheless it is clear that the resulting math shows 54 out of 105 returns owing no additional taxes on reclassified wages.

In short, some of the failure to report returns listed by the IRS in its noncompliance figures must include returns upon which the tax due on the unreported "wages" was zero. Even the layman understands that the failure to report something upon which no taxes are due is an issue of little or no importance to the administration of the tax laws. What has happened here is that the Treasury has chosen to find noncompliance in a manner that will produce the most impressive figures in Treasury's opinion.

The inconsistencies in Treasury's analysis of its own inadequate information are, in most instances, found in its compliance conclusions. Another example can be found in the Format B Tables, Vol. I, Table 2, p. 29, where a 100% compliance rate is applied to 21 of the 105 returns in the logging and timber category. But Basic Tables, Vol. II, Table 4, shows 24 individuals fully reporting all income. Why then are not these other three people put in the 100% compliance rate in Format B Tables, Vol. I, Table 2? The noncompliance allegedly found by the IRS can be more realistically summarized as follows:

Number of Returns	Amount Owed
1	$ -50.00
24	00.00
48	20.83 each
13	153.85 each
10	350.00 each
6	666.67 each
3	1,667.67 each

Even more importantly, it appears that the individual in the logging and timber category used by the IRS in this study is not the same kind of individual most frequently found in the logging and timber industry. While the study fails to break down the returns into part-time and full-time labor, it is fairly clear that many part-timers are included in the logging and timber category. While a large representation of part-time workers might or might not be appropriate in some industries, it is certainly not appropriate in the logging and timber industry. A farmer may occasionally sell a load of timber from his farm in order to prepare a pasture for a particular use. Similarly, investors might occasionally sell timber from their land as they clear it for a vacation home. However, the worker who should be representative of the independent contractor in the logging and timber industry is the one who makes his living in the logging and timber industry. On the other hand, the great bulk of the workers used in the logging and timber category in this study are not persons making their livelihood in the industry, but rather individuals who may supplement their income from their main career by the sale of an occasional load of wood.

This conclusion cannot be derived from the casual and noncasual categories, but from the sums of money not reported by those who did not report any of their earnings in the logging and timber industry for 1976 or 1977. No full-time worker would be earning small, insignificant sums. Most of the workers included in the logging and timber category of the study are shown as earning small sums for the year. It is probable, therefore, that most of them are part-time workers, a type of worker who is not at all representative of our industry.

There are 50,000,000 cords of roundwood produced each year in this country, resulting in an average man-day production rate of 4.7. ("Predicted Forestry, Harvesting and Pulpwood Procurement Conditions for the Years 1980 and 2000.") It would require over 50,000 forest workers to maintain these daily production rates. The U.S. Forest Service's recent study estimating the total number of logging workers in the country, using 1972 data, places the logging industry workforce at 190,000 workers, ranging from gum gatherers in the South to Christmas tree harvesters in the North. Even when the IRS sample used in the lumber and timber category is compared only to pulpwood production workers, the percentages are unrepresentatively low.

District	Number Workers Sampled	Calculated Total Number Workers in Pulpwood Production	Percentage Sampled
Central	8	2,200	.36%
Mid-Atlantic	2	3,300	.06%
Midwest	22	2,300	.96%
North Atlantic	9	3,500	.26%
Southeast	29	19,000	.15%
Southwest	22	8,000	.28%
TOTALS	105*	38,300	.27%

As the above table shows, there are only nine workers included in the IRS study from the entire North Atlantic district. One of those workers is in Maine and five are in Vermont, leaving three workers to represent the huge forest industry in New England and New York. Indeed, the one worker found in Maine must represent over 2,000,000 annual cords of wood production, not to mention saw logs, veneer, and other forest products. Since we do not know very much about the worker, he could have been a farmer who cut two loads of pulpwood or logs in order to clear a pasture. Six of the workers placed in the logging and timber category by the IRS listed themselves as farmers when questioned by the IRS agent.

The Central region, covering Michigan, Indiana, Ohio, Kentucky, and West Virginia contains only eight workers to represent the entire area, despite the importance of the logging industry in all five of those states. It is possible, of course, that all eight representatives came from one open case.

In the Mid-Atlantic district there are only two workers, or rather two returns, possibly constituting only one worker, representing Pennsylvania, New Jersey, Delaware, Maryland, and Virginia. Neither of the two returns involved in the Mid-Atlantic region came from Virginia, even though wood production in Pennsylvania and Virginia ranks with the highest in the country. A similar nonrepresentative character can be found in the workers chosen for the other regions.

One of the most glaring inconsistencies found was the IRS' apparent inability to identify the worker's occupation and industry. The field agents who did the interviews were not given any definitions to use in placing a worker in a particular industry or occupation. Rather, that determination was left to the discretion of each individual field agent. Field agents questioned as to the type of people included in the logging and timber category varied in their opinion as to whom would be includable. One field representative even placed treegrowers, treecutters, and saw mill workers all together in the same logging and timber category.

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*Includes the 13 who were found to be in compliance.

Only 91 of the 105 workers used in the logging and timber category agreed with the Service that they belonged in the logging and timber industries. Two placed themselves in real estate, one in direct sales, six in other sales, two in the trucking industry, one in the home improvement business, one in an unidentified "other" category, and one simply did not know what industry he was in. (Format A Tables, Vol. I, pp. 49-50.) It is difficult to understand why, when the IRS found a worker who was in real estate, direct sales, trucking, or home improvement, that worker was not added to the list of workers for those industries rather than left in logging and timber. It is also difficult to imagine a worker's not knowing to which industry he belonged - unless, of course, the worker was never consulted on the matter.

In short, the study utilized a nonrepresentative sample - a "sample of opportunity" - invoked unorthodox methods, and analyzed to reach an apparently predetermined, desired result. Under these circumstances, the study does not even rise to the level of speculation.

The IRS' conclusion at the time of the Treasury study was to request the institution of withholding on payments to independent contractors. We remain adamantly opposed to mandatory withholding. Our reason is quite simple - it will lead to the demise of the small logging businessman.

Flat rate withholding on a gross amount paid bears no relationship to business realities in the logging industry. The amount paid is not profit. The amount paid is not income. In fact, depending on market conditions, it may involve a loss. From amounts paid to him, a logger must pay his employees, pay landowners, pay for equipment, meet the costs of repairs, supplies, fuel, lubricants, and insurance - all of the normal costs of operating a business.

What is reflected in any withholding proposal is an abysmal ignorance of the free enterprise system. That is especially true with respect to the economics of a raw material-based economy.

Logging is unique in terms of its capital equipment requirements. The type and quantity of capital expenditure may vary considerably by region. For example, logging equipment required in the northwest United States, given the terrain and sheer size of standing timber, may vary considerably from that required in the southeastern coastal plain. However, even given the variances in capital equipment mix, one absolute truth covers logging and pulpwood operations - heavy equipment is essential to the performance of the service, and all such equipment is extremely expensive.

In most instances an entire equipment mix is essential to a contractor. Most contracts are negotiated on a delivered basis. Therefore, the contractor must have available everything necessary to fell the trees, transport them within the forest, load them from a point within the forest to on-the-road equipment, and finally transport them over the road to the delivery point. This "snapshot" is a picture of the type of logging and pulpwood contractor APA is seeking to protect against future arguments concerning status as independent businessmen.

It should also be noted that the products produced by APA members are essentially raw materials, not final products in and of themselves. Consequently, the demand for the service and therefore its value is derived. For example, the sharp and prolonged downturn in housing has had a significant negative effect upon the demand for and value of the services of logging contractors. Recent published reports reflect a significant downturn in the demand for paper products. Contractors for pulpwood are presently experiencing a scenario very similar to that experienced by contractors whose predominant business operations were geared to raw materials used in the housing industry.

The foregoing amply demonstrates that logging is a series of financial variables. The price for the service is a variable and is derived from demand in end use markets. Fuel, lubricants, wages paid, interest on capital financing, repairs, operating conditions (terrain, tree size, weather), equipment - all are costs and all are variables. All are also variables with high velocity. The recent events in fuel prices and interest rates attest to that premise. Therefore, a logger's return (income) on sales, either product or service, is a variable and an unpredictable variable.

Withholding against a variable is absurd. In point of fact, under current market conditions for loggers, a withholding tax would probably represent a confiscatory tax. The result of a confiscatory tax should be obvious. It is the premise upon which we began - withholding would be a lethal blow to the independent logging businessman. We can virtually assure you that the final chapters of the withholding saga would be Chapter VII, X, or XI of the United States Bankruptcy Code.

What is Really at Stake

There is a natural human tendency to want the best of all worlds. Who would not prefer complete freedom to make all business decisions, to be accountable to no one, and also to have all the security characteristic of an employment relationship?

However, a difficult choice prevails. To be an independent businessman, one foregoes the security of employment, becomes accountable to the marketplace, and becomes directly responsible for taxes and insurance required. To be an employee, one foregoes the right to determine the manner and means of performance and becomes accountable to an employer, while the employer serves as an agent of government in tax withholding and other legally mandated employer responsibilities.

What is at stake here for all industry and particularly for the logging industry is that this choice could be significantly influenced by a return to IRS practices prevalent before 1979, rather than by business reality and economic factors. The net result over time is a probable massive reallocation and misallocation of scarce economic resources.

Previous IRS practices seem to have been based on the mistaken notion that tax considerations are a "high stakes" factor in making the decision to utilize the services of, buy from, or sell through independent contractors. This narrow view does not comport with the real world of economic relationships that exists in the logging business. The reality of logging is simply that the tax laws do not and cannot determine whether or not employees or independent contractors are used. Rather, regional land ownership patterns, market availability, the nature of regional timber stands, capital considerations, equipment considerations, landowner preferences, financing considerations, economic merchandizing of harvested timber, distance to market, and a host of other economic and entrepreneurial forces are at play. In logging, independent contractors exist and are successful only in the business relationships where their products and services maximize the economic return from all resources.

The worst possible consequence for APA members is a return to pre-1979 conditions, when IRS actions had the effect of forcing legitimate independent businessmen into an unwanted and economically wasteful employment status. Ease of tax administration was being placed above the benefits that accrue from independent entrepreneurial activity.

Conclusion

S. 2369 is the solution to the real problem before us today: status. It brings predictability and clarity to an area that has been made unnecessarily confusing. It will enhance tax compliance without supplanting the common law test and without disturbing economic relationships of proven efficiency and workability.

We fully support better reporting, and we will continue our own efforts to make sure that those in our industry know their proper tax obligations.

Mr. McRae. Mr. Chairman, could I take about 15 seconds? I got nervous about that yellow light. And I won't take more than the time I had.

Senator Grassley. That still gives you 1 more minute.

Mr. McRae. Well, I know. But I worried about how long he was going to stay on. [Laughter.]

Our statement covers the issue of SECA, the self-employment tax, versus the FICA income to the Government. We don't agree that the total burden is less to any degree. We believe it is primarily a matter of shifting the tax burden to the general revenues as distinguished from the trust funds. And that's what I wanted to get in. Thank you very much.

Senator Grassley. I have a couple of questions. Mr. Rolston stated his position clearly on this, but I wanted to ask all of you. Are there nontax reasons that individuals in your industry like to be classified as independent contractors?

Mr. McRae. The fellows that we deal with in the trucking business are just about as independent as you can get. [Laughter.]

Senator Grassley. It appears that way when I meet them on the road. [Laughter.]

Mr. McRae. You have got a few crazies in every group. [Laughter.]

But, no, sir. Our guys are truly proud of being independent. And it certainly isn't a tax basis. As Ken said, we didn't do this to beat the tax rap. That's just the way they are.

Senator Grassley. Mr. Golden.

Mr. GOLDEN. Mr. Chairman, I would answer in the same way insofar as the independence of our people are concerned. However, I think I can go a little bit further. My particular company and one other major company that I know of in the industry has tried employees. We did not do very well with quality control. And I think I could assure you that our shippers would also prefer to have the service of the independent businessman who is motivated. The problem of control is one that must be left to the individual contractor.

Senator GRASSLEY. Let me clarify what I was saying. I was being facetious about truckers, I've never had any trouble on the road at all.

Mr. MCRAE. All right. [Laughter.]

Senator GRASSLEY. On one or two occasions a trucker has been very helpful to me in an emergency situation. I was referring to the size of the rig. It is somewhat intimidating in the sense of the massive size.

Let's see. One of you addressed withholding. But for those of you that didn't I would like to have your comment on whether withholding would ever be an appropriate solution to the problem that we are addressing in this bill vis-a-vis your industry.

Mr. MCRAE. I addressed it in ours. But, in fact, because of the heavy over withholding that would be involved because of the heavy expenses these fellows have, it would really be tough in our segment of the business to do it right.

Mr. GOLDEN. Mr. Chairman, in the income fluctuation area, our drivers have heavy expenses. And it does fluctuate greatly from one driver to another. We think it would be impossible to come to any sort of a uniform system that would be possible to administer.

Mr. ROLSTON. We don't know how in the world you would put it in place. You would have to withhold on the stumpage payments to landowners. You would have to withhold on the payments to the Catepillar Tractor Co. It just doesn't make any sense.

Senator GRASSLEY. One other general question for all of you. How do you view the problems that we are trying to address in this legislation? Do you feel that there are significant compliance problems with your industry?

Mr. MCRAE. I don't think they are significant compliance problems. Certainly I am sure there are compliance problems. But most of the regulated industry, the people who utilize independent owner-operators in the trucking business have, for years, supplied 1099's to the men, and given them copies, in addition to supplying the 1099 to the Government. They have substantial gross incomes. And what we know of their actual compliance is great.

Mr. GOLDEN. Mr Chairman, my own company has provided 1099's for a great number of years. I don't know how many. But I do believe that within that period of time, considering the number which runs into the thousands, that we would have had more feedback and would have known more about it than we have seen. In addition, to go back to the findings of the—whoever made the study—Duncan, the average income of the independent contractor in the household goods field in 1980 was $82,000. I don't think you fail to pay on that sort of an income. I don't think it's a problem.

Senator GRASSLEY. Did you have something you wanted to add?

Mr. **Delancy**. Mr. Chairman, let me just say that while the original Internal Revenue Service compliance study indicated a relatively low-compliance ratio for the trucking industry, less than half of the universe they were testing were truckers. The General Accounting Office study on the exact match file, which is a better classification study, looking at the trucking industry, reflected a compliance level of approximately 90 percent on actual filing. And somewhere in the neighborhood of 92 to 93 percent on reporting. Now, the SECA taxes reported on the form SE, which is a part of your 1040—so you don't file your SECA information and not file your income tax return and report your income. And, again, it's the level of income. Both the Treasury Department and the General Accounting Office reflected an excess of 90-percent compliance when your gross income is in excess of $50,000. So we really think that the compliance level—a 10-percent variation or 8 percent is bad, but it is nowhere near as bad as what was spoken to originally.

Senator **Grassley**. Mr. Rolston.

Mr. **Rolston**. We sure don't think that there's a significant compliance problem. In fact, we feel the data the IRS came up with might have included some of those fellows that probably come up to your door with a load of firewood. We don't call them logging contractors.

The only feedback we got from the special IRS studies made from our industry was sort of interesting. The IRS said that some of these contractors had difficulty filling out their returns properly. Well, I've got difficulty filling out and understanding my return too. So if that's a problem there——

Senator **Dole**. It's so difficult that 5 million people didn't even do it. [Laughter.]

Senator **Grassley**. Senator Dole, you have questions?

Senator **Dole**. I understand you generally support the legislation. Is that correct?

Mr. **Golden**. Yes, sir.

Senator **Dole**. We will be working either with you directly or with staff as we try to move this thing along as quickly as we can. We appreciate very much your testimony.

Senator **Grassley**. That's all the questions we have. Thank you very much for your contributions.

Our next panel consists of Mr. John D. McNeer, senior vice president, Newton Manufacturing Co., Newton, Iowa. And John is speaking on behalf of the Specialty Advertising Association International, offices in Washington, D.C.; Jay Van Andel, chairman of the Amway Corp.; and James J. Gibbons, president of the Manufacturers Agents National Association, Irvine, Calif., on behalf of the association and on behalf of the Small Business Legislative Council, Washington, D.C.

Mr. McNeer is a constituent of mine. He's senior vice president in charge of marketing for the Newton Manufacturing Co. of Newton, Iowa. Mr. McNeer has been with the company for 10 years. His company has been in the business since 1901, and I want to welcome him here as a constituent as well.

STATEMENT OF JOHN D. McNEER, SENIOR VICE PRESIDENT, NEWTON MANUFACTURING CO., NEWTON, IOWA, ON BEHALF OF THE SPECIALTY ADVERTISING ASSOCIATION INTERNATIONAL, IRVING, TEX.

Mr. McNEER. Thank you, Mr. Chairman, and members of the subcommittee. My name is John D. McNeer. And I am the senior vice president of the Newton Manufacturing Co. in Newton, Iowa. I'm appearing here today on behalf of the Specialty Advertising Association. And with me is H. Ted Olson, president of the association.

We appreciate this opportunity to testify on behalf of our association on proposals for legislation relating to independent contractors.

The specialty advertising industry is composed of approximately 6,000 firms, which either manufacture or sell specialty advertising products. Such products consist of useful items, such as this ball pen, which are imprinted with an advertising message and are distributed free of charge for advertising purposes. Our products are sold to advertisers by approximately 30,000 salespersons who are independent contractors under the common law rules.

Our industry has faced the same problems resulting from IRS reclassifications of its salespeople as employees which others have testified about today, and at the previous hearings. We, therefore, support the enactment of clear safe harbor tests for determining independent contractor status as are contained in S. 2369.

We are concerned, however, because under S. 2369 the safe harbor tests would not apply to so-called traveling or city salesmen for purposes of income tax withholding. Under the language of an earlier bill, S. 8, the safe harbor tests would apply to traveling or city salesmen for the purposes of withholding tax.

We are here this afternoon to ask that similar language be incorporated in S. 2369 or in any final bill on this subject. Let me briefly explain the reasons for this request.

Distributor firms in our industry have to make two difficult determinations about the tax status of their sales persons. The first is whether they are employees or independent contractors under the common law test. The second is whether they fall within the complex and confusing definition of traveling or city salesmen set forth in section 3121(d) of the Code. Under that section, traveling or city salesmen and certain others who qualify as independent contractors are treated as statutory employees for purposes of social security and unemployment compensation, but not for income tax withholding.

Under S. 2369, the safe harbor tests would not apply to such persons for any purposes, including income tax withholding. Thus, if the bill were enacted, we would still have to rely exclusively on the common law test to determine whether to withhold income tax from the commissions paid to such persons.

Mr. Chairman, we know of no reason why the safe harbor tests should not apply to traveling or city salesmen at least for purposes of income tax withholding. The main reasons for having such tests is to provide greater clarity and certainty in classifying workers for tax purposes. These reasons apply with equal force to the classification of traveling salesmen. In our view, it would be particularly unfair to deny our industry the benefits of such tests since we will continue to be faced with the equally difficult determination of whether salespersons come within the traveling salesmen definition. In this respect, I believe we have an even greater need for relief from the complexities of the employment tax laws than some other industries.

In conclusion, Mr. Chairman, we, again, ask that the language in S. 8 on this point be inserted into S. 2369 or in any final bill on the subject. We support the other provisions.

I thank you.

[The prepared statement follows:]

STATEMENT OF JOHN D. McNEER

ON S.2369 THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE BILL OF 1982

ON BEHALF OF THE

SPECIALTY ADVERTISING ASSOCIATION INTERNATIONAL

Mr. Chairman and Members of the Subcommittee:

My name is John D. McNeer. I am Senior Vice President of the Newton Manufacturing Company of Newton, Iowa. I am a former member of the Board of Directors of the Specialty Advertising Association International (SAAI) and I am appearing today on behalf of that Association. Accompanying me is H. Ted Olson, President of our Association. We appreciate this opportunity on behalf of SAAI to discuss S.2369, the proposed "Independent Contractor Tax Classification and Compliance Act of 1982."

Summary Of Views

SAAI supports enactment of the safe-harbor tests for determining independent contractor status that are set forth in S.2369. However, we oppose the language in section 3508(c)(2) of that bill which would render those tests inapplicable to "traveling or city salesmen" for income tax withholding purposes. We strongly believe that the safe-harbor tests should be made applicable to "traveling salesmen" for income tax withholding purposes. The same need for clarity and certainty exists in classifying such persons as employees or independent contractors as exists with respect to other workers. Firms that rely on "traveling salesmen" have a particular need for relief from the complexities of the employment tax laws, because they face the doubly difficult burden of applying both the common law test and the equally confusing "traveling salesmen" test. We believe many such firms would reclassify their salesmen as employees rather than again face the severe uncertainties of the common law test. Yet, such reclassifications would have a harmful effect, since they would be contrary to the desires of most specialty advertising salespersons who want to be their own bosses.

SAAI does not object to provisions in S.2369 that would impose greater penalties for failure to report payments to independent contractors. We view this as a reasonable alternative to income tax withholding on independent contractors--which we strongly oppose.

The Specialty Advertising Industry

The Specialty Advertising Association International is the trade association that represents the specialty advertising industry. Its 2,600 member firms, located in virtually all states, manufacture or distribute specialty advertising products. Specialty advertising is an advertising medium which uses useful but inexpensive items to carry an advertising message. Examples of such products are ballpoint pens, key chains, and calendars which are custom imprinted with the name, logo or other identification of the advertiser and distributed free of charge for advertising or promotional purposes. In 1981 sales of specialty advertising products by all firms in the industry were in excess of $3 billion. There are approximately 6,000 firms in the industry, the overwhelming majority of which are small businesses.

Manufacturers of specialty advertising products sell their merchandise through firms known as distributors. Distributors receive orders from salespersons who make the actual contacts with the advertisers and who sell the products to such advertisers. The salespersons typically derive their income solely from commissions and operate away from the premises and free from the control of their principals. There are approximately 30,000 of such salespersons and the great majority of them are independent contractors under the usual common law rules.

Independent Contractors In The Specialty Advertising Industry

The dynamic growth of the specialty advertising industry in the past 10 years has been achieved in large part as a result of the independent contractor salespersons who sell the industry's products. Such persons place a high value on being independent in carrying out their work. They prefer to be their own bosses, to control their own hours, to solicit the accounts of their own choosing, to keep their own records and books and to conduct their business away from any office or fixed location. They do not regard themselves as employees and do not wish to be so treated.

Most specialty advertising salespersons work full or part time on behalf of one principal. They solicit orders from virtually all types of business firms and other entities that desire to use the specialty advertising medium. Potential buyers include not only business firms, such as manufacturers, wholesalers, retailers and financial institutions, but also nonprofit organizations, political parties and candidates, government institutions and many other entities. While some salespersons specialize in soliciting certain accounts, most sell to a wide variety of businesses and other entities.

For a number of years, specialty advertising distributors, for whom the independent contractors perform selling services, have been faced with two exceedingly difficult tax problems regarding their salespersons. One is whether the salespersons will be classified by the IRS under common law rules as employees for employment tax purposes. The other is whether the salespersons--even though clearly independent contractors under the common law tests, will nevertheless be regarded as "traveling or city salesmen" (and therefore statutory employees) for purposes of social security (FICA) taxes and unemployment compensation taxes (FUTA) under section 3121(d)(3)(D) of the Internal Revenue Code and regulations.

The Subcommittee is well aware of the first of these two problems. The lack of uniformity and unfairness in IRS' interpretations of the common law tests led to the passage of section 530 of the Revenue Act of 1978 (P.L. 95-600), and subsequent extensions of that law, which provided interim relief from IRS reclassifications of workers as employees for tax purposes. Since that time, considerable testimony has been presented on the need for certainty in classifying workers as employees or independent contractors for tax purposes.

Our Association is in complete agreement on the need for certainty in this respect and supports the enactment of legislation which would provide clear and objective tests for determining independent contractor status.

We point out, however, that our industry also has been faced with another equally serious problem in determining the status of its salespersons. The problem results from the exceedingly complex and confusing definition of "traveling or city salesmen" contained in section 3121(d) of the Code. Under that section, traveling or city salesmen who qualify as independent contractors are treated by statute as employees for purposes of social security (FICA) taxes and unemployment compensation (FUTA) taxes, but are not subject to income tax withholding. We do not have statistics showing how many of the 30,000 salespersons in the specialty advertising industry are "traveling or city salesmen." We believe, however, that a significant percentage may come within that category.

Section 3121(d) of the Code defines "traveling or city salesmen" as follows:

* * * * * * * * *

> (d) Employee.--For purposes of this chapter, the term "employee" means--
>
> (3) any individual (other than an individual who is an employee under paragraph (1) or (2)) who preforms services for remuneration for any person--
>
> (D) as a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) or orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations;
>
> if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in

devoted 80 percent or more of his time selling to "wholesalers, retailers, contractors, or operators of hotels, restaurants or other similar establishments."

Frequently, however, it is unclear whether the business firm comes within the specified categories. Some of the major users of specialty advertising do not clearly fall within these categories, e.g., banks, savings and loan associations, credit unions, insurance companies, and trucking lines. Moreover, the only way a salesperson could know if he spent 80 percent of his time selling to the specified categories of firms would be for him to keep careful records of each hour he spent in his work. However, to require independent contractor salesmen to keep such records is highly impractical.

Finally, in many cases it is difficult to determine whether a salesperson in a given calendar quarter was a "multiple line salesmen" or a salesman who worked primarily for one principal and engaged in only "side-line sales activities." For one thing, the meaning of the term "side-line sales" is far from clear. Moreover, to obtain such information from an independent contractor salesman about his activities would require exercising direction and control to a degree that could well cause the salesperson to be regarded as an employee under common law rules.

In sum, specialty advertising firms that use salespersons that could be classified as "traveling or city salesmen"

> facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed.

* * * * * * * * *

A revenue ruling provides in part that "[g]enerally, a traveling or city salesman will be presumed to meet the"principal business activity" test in any calendar quarter in which he devotes 80 percent or more of his working time and attention to the solicitation of orders for one principal from wholesalers and/or the other customers specified for merchandise for resale or supplies of the requisite character." (Rev. Rul. 55-31, ¶3(a))

To further complicate the problem of interpretation, an IRS regulation says that "multiple-line salesmen" who solicit orders on behalf of other principals are not included within the definition unless their solicitation of orders for other principals consists only of "side-line sales activities." (IRS Reg. §31.3121(d)-1(iv)(b))

Section 3121(d)(3)(D) and the rulings and regulations interpreting it create truly horrendous compliance problems for specialty advertising distributors. Under this section, during each calendar quarter the distributors must make the complex and burdensome determination whether any of its salespeople presently must make two difficult determinations: (1) whether the salespersons will meet the common law tests for independent contractor status; and (2) whether in any calendar quarter they come within the definition of "traveling or city salesmen."

S.2369

The Specialty Advertising Association International supports the "safe-harbor" definitions contained in S.2369, because we believe those definitions provide much needed certainty in classifying workers as independent contractors for employment tax purposes. However, we strongly disagree with the wording of section 3508(c)(2) of the bill which provides that the safe-harbor definitions would not apply to "traveling and city salesmen" (and other individuals described in section 3121(d) of the Code).

We understand why the definitions should not apply for purposes of social security taxes, since under current law the individuals described are treated as statutory employees for purposes of social security and unemployment compensation taxes. But there is no logical reason why the bill's safe-harbor provisions should not be applied to such individuals for purposes of income tax withholding. Indeed, all of the reasons for having safe-harbor definitions in the first place apply with equal force to "traveling or city salesmen." Firms in our industry that have such salespersons share the same need for clarity and certainty regarding the proper tax classification of their workers as any other firms that use independent contractors. Moreover, it would be particularly unfair to deny such firms the benefit of the safe-harbor definitions, since they face the doubly difficult burden of having to apply both the common law test and the "traveling salesman" test. They should be among the most deserving of the relief from uncertainty provided by the safe-harbor tests.

Finally, preventing the tests from applying to "traveling salesmen" would undoubtedly force many of our industry's firms to treat their salespersons as employees for all purposes. Many would seek to do this rather than again face the severe uncertainties of the common law tests and IRS's apparent willingness to exploit those uncertainties. The reclassification by such firms might be fine from the standpoint of the IRS, but it would hurt our industry. The salespersons, on whom we rely so heavily, are staunchly independent. They do not want to be treated as employees. Many would rather leave the industry if they could no longer be their own bosses.

Under the language of an earlier bill introduced by Senator Dole, S.8, the safe-harbor tests would apply to "traveling salesmen" (and others in section 3121(d)) for purposes of income tax withholding. We strongly urge that such language be inserted in any final bill on this subject. The language, which appears in section 3508(c)(1) of S.8, is as follows:

* * * * * * * * *

> "(c) Special Rules.--
>
> "(1) Section Not To Apply To Certain Individuals For Purposes of Social Security Taxes.-- For purposes of chapters 2 and 21, this section shall not apply to an individual described in section 3121(d)(3) relating to certain agent-drivers, commission-drivers, full-time life insurance salesmen, home workers, and traveling or city salesmen)."

* * * * * * * * *

The Specialty Advertising Association International does not object to provisions in S.2369 which would impose greater penalties for failure to report payments to independent contractors. We accept such provisions as a reasonable alternative to income tax withholding and believe that they should substantially alleviate any problems of unreported and underreported income.

Conclusion

Taxpayers in the specialty advertising industry and other taxpayers concerned with classifications of workers as employees or independent contractors have long faced difficult problems with the IRS. We therefore commend the Subcommittee for addressing this subject and seeking ways to provide much needed clarity and simplification in coping with these problems. Since such clarity is equally important in tests applicable to "traveling or city salesmen," we urge that the safe-harbor provisions of S.2369 be applicable to such persons for purposes of income tax withholding.

Senator **Grassley**. Jay.

STATEMENT OF JAY VAN ANDEL, CHAIRMAN, AMWAY CORP., WASHINGTON, D.C.

Mr. **Van Andel**. Thank you, Mr. Chairman. I'm Jay Van Andel, chairman of the board of the Amway Corp. Amway is one of the world's largest direct selling companies with somewhat over 1 million Amway distributors worldwide. At least 750,000 of those are in the United States. And at any given time, probably 1 million during the year are active here.

I'm presenting my written testimony to you for the committee's use. And in the interest of time, I will simply summarize extemporaneously a few of our points.

In general, we are in agreement with the provisions of the bill. We believe, however, that it is very important in the area of the independent contractors, whether it's Amway distributors or other independent contractors, to keep life as simple for them as possible. Independent contractors, to a large degree, are the starting point of new entrepreneurs in our business system. And the more of a load we put on them, the more paperwork we put on them, the more likely it is that some will not even start. And if we don't get starters, we don't get finishers.

So we are somewhat concerned in general about the complexity of the Tax Code itself. I don't think any reasonable person would not want independent contractors to pay their taxes. All people should pay their taxes. But how we get at it, whether we make it simple or whether we make it complicated, is of importance to us.

We certainly are in support of the general provisions of the bill. The safe harbor measure is fine as far as we are concerned. We are somewhat concerned about the 1099 provisions. We recognize in the direct selling business that there are a lot of different companies that operate in different ways. And, therefore, it's very difficult to design a reporting requirement that satisfies everyone. Nevertheless, it seems to us that the proposals here are somewhat complicated. We feel that the proposal that has to do with reporting either $600 in remittances or over $5,000 in gross sales is not really the best way to get at this problem because gross sales don't really represent accurately profits made. And to provide the IRS with gross sales figures, we think, gives them figures that aren't of really great value to them, and simply cause a lot of additional paperwork. As far as 1099's are concerned, we, like most companies, have provided 1099's for years. In fact, we provide them right now down to $1, so that's no problem for us.

We do think that the alternative system that is proposed in the bill of providing 1099's for those who receive less than $50 in bonuses but purchase more than $50 a product in a year for resale is not a realistic system for giving IRS information. In our case, our beginners' sales kit for resale costs over $50—so effectively we would be providing pieces of paper to IRS without any reporting, simply names and social security numbers for almost every Amway distributor in the country. IRS would probably get a million pieces of paper a year from us. And that seems to us not to be a very reasonable system.

We think it would be better to stick to simply using the 1099's for reporting bonuses all the way down to $1 if you want to go that way or $50 or whatever threshold you wish. If on the other hand you think it is really necessary to have a sales provision, a minimum sales provision, then we think $1,500 a year would be better than $50 a year because it seems that that's about $125 a month in bonus earnings. And that would be about the threshold level where you would get some degree of profitability that would be worth IRS' trouble to investigate if they wished.

We think, however, a better way and a simpler way that would eliminate a lot of paperwork would be simply to have a checkoff box on the 1040 where you check off and say that you were an independent contractor. If IRS wants a paper trail, then they have already got those pieces of paper. And we also think that it would be sensible to require that the 1099's be submitted with the 1040's because even though there might not be an entry in the computer, just the submission of the 1099 would tend to make people feel that that figure is reported and they had better pay tax on it.

Senator DOLE. I think that's a good idea.

Mr. VAN ANDEL. I think those two things we submit as ideas for you. Otherwise, in general, we are in concert with the bill. And I think we are going in the right direction. And we ought to get on with it, and get it taken care of.

[The prepared statement follows:]

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

MY NAME IS JAY VAN ANDEL. I AM CHAIRMAN OF THE BOARD OF AMWAY CORPORATION. WITH ME TODAY IS JOHN GARTLAND, DIRECTOR OF THE AMWAY WASHINGTON OFFICE.

I AM HERE TODAY TO SPEAK TO YOU CONCERNING OUR DEDICATION TO PARTICIPATE AS FULL AND EQUAL TAXPAYERS FROM AN INDUSTRY THAT IS AS OLD AS OUR COUNTRY. OUR HISTORY IS ONE TO BE PROUD OF -- INDEPENDENT ENTREPRENEURS WHO DEPEND ON THEMSELVES AND THEIR SERVICES OR PRODUCTS TO ACHIEVE A PROFIT.

TWENTY-THREE YEARS AGO, MY PARTNER RICH DEVOS AND I STARTED A DIRECT SELLING COMPANY IN OUR BASEMENTS. SINCE THAT TIME, AMWAY HAS GROWN TO BE ONE OF THE WORLD'S LARGEST DIRECT SELLING COMPANIES WITH ESTIMATED RETAIL SALES OF MORE THAN 1.4 BILLION DOLLARS IN 1981.

AMWAY PRODUCTS INCLUDE ITEMS FOR HOME AND PERSONAL CARE, AUTO CARE, COMMERCIAL AND INSTITUTIONAL USE, AS WELL AS COSMETICS, HOSIERY, COOKWARE, AND VITAMINS. AMWAY ALSO MAKES AVAILABLE HUNDREDS OF FAMOUS NAME-BRAND ITEMS FROM CLOTHING TO RUGS, FROM SMALL APPLIANCES TO WATCHES, THROUGH OUR AMWAY PERSONAL SHOPPERS SERVICE.

AMWAY IS HEADQUARTERED IN ADA, MICHIGAN, AND ALMOST ALL AMWAY PRODUCTS ARE MANUFACTURED AT ADA OR BY NUTRILITE PRODUCTS, INC., OUR SUBSIDIARY AT LAKEVIEW AND BUENA PARK, CALIFORNIA, OR IN OUR RECENTLY ACQUIRED SUBSIDIARY, STATITROL, INC., IN LAKEWOOD, COLORADO. THE COMPANY AT PRESENT ALSO DISTRIBUTES ITS PRODUCTS IN 25 COUNTRIES AND TERRITORIES. ALL AMWAY PRODUCTS ARE SOLD ONLY THROUGH INDEPENDENT AMWAY DISTRIBUTORS.

THROUGH THE AMWAY SALES AND MARKETING PLAN, PEOPLE FROM EVERY WALK OF LIFE HAVE BEEN ABLE TO ESTABLISH SUCCESSFUL, INDEPENDENT BUSINESSES IN THE DIRECT SELLING INDUSTRY. IN A WORLD THAT IS GROWING MORE IMPERSONAL DAILY, PERSONAL SELLING -- WITH ITS EMPHASIS ON QUALITY PRODUCTS AND DEPENDABLE SERVICE -- IS EXPERIENCING AN EXCITING REBIRTH.

TODAY, THERE ARE MORE THAN ONE MILLION AMWAY DISTRIBUTORSHIPS WORLDWIDE. 750,000 OF THESE ARE IN THE UNITED STATES, DELIVERING MORE THAN 350 DIFFERENT PRODUCTS RIGHT TO THEIR CUSTOMERS' HOMES. SOME OF THESE DISTRIBUTORSHIPS ARE WOMEN, SOME MEN, BUT MOST ARE ACTUALLY HUSBAND AND WIFE TEAMS, MAKING AMWAY DIRECT SELLING VERY MUCH A FAMILY BUSINESS. MANY HAVE CHOSEN TO USE THE AMWAY BUSINESS TO SUPPLEMENT THEIR PRIMARY INCOME, WHILE OTHERS HAVE MADE AMWAY THEIR FULL-TIME CAREERS. TO BECOME AN AMWAY DISTRIBUTOR, THE INITIAL COST IS AS LITTLE AS $35.00, WHICH IS FULLY REFUNDABLE. A PERSON JOINS THE WORLD OF AMWAY BY BEING SPONSORED BY A CURRENT AMWAY DISTRIBUTOR.

A STRICT CODE OF ETHICS GOVERNS THE BUSINESS PRACTICES OF EVERY DISTRIBUTOR. AMWAY DISTRIBUTORS BUILD THEIR BUSINESSES THROUGH THEIR OWN RETAIL SALES AND BY SPONSORING, TRAINING, AND MOTIVATING OTHER DISTRIBUTORS. AMWAY DISTRIBUTORS SUCCEED AS SPONSORS ONLY WHEN THEIR SPONSORED DISTRIBUTORS SUCCEED IN SELLING PRODUCTS. AMWAY DISTRIBUTORS DO NOT PAY FOR THE RIGHT TO SPONSOR OTHERS. THERE ARE NO FRANCHISE FEES OR INITIAL INVENTORY REQUIREMENTS.

ONCE A DISTRIBUTOR ACHIEVES A HIGH LEVEL OF SALES VOLUME THROUGH HIS OWN RETAIL SALES AND THE COMBINED VOLUME OF THOSE HE HAS SPONSORED, THE DISTRIBUTOR BECOMES A DIRECT DISTRIBUTOR. AS A DIRECT DISTRIBUTOR, HE DEALS DIRECTLY WITH THE COMPANY AND NO LONGER WITH THE DISTRIBUTOR WHO SPONSORED HIM. THEREFORE, THE MAJORITY OF INDEPENDENT AMWAY DISTRIBUTORS DO NOT DEAL DIRECTLY WITH AMWAY, AND MOST LIKELY CONDUCT THEIR BUSINESSES AS PART-TIME BUSINESSES.

ONE OF THE IMPORTANT PRINCIPLES OF OUR SUCCESS HAS BEEN KEEPING THE SYSTEM AS SIMPLE AS POSSIBLE -- THEREBY MAINTAINING LITTLE OVERHEAD AND PAPERWORK FOR THE DISTRIBUTORS. THIS ALLOWS PEOPLE TO ENTER THE AMWAY BUSINESS WITH LITTLE OR NO BUSINESS EXPERIENCE, YET TO ENJOY THE FREEDOM OF HAVING THEIR OWN BUSINESS AND BEING THEIR OWN BOSS. AS I MENTIONED EARLIER, THERE ARE THOUSANDS OF PEOPLE WITHIN THE WORLD OF AMWAY. EACH IS AN INDIVIDUAL, YET ALL SHARE A BELIEF IN THE FREE ENTERPRISE SYSTEM.

I DO WISH TO STATE TODAY THAT I FIND IT SOMEWHAT DISCONCERTING THAT WE ARE GATHERED HERE TO DISCUSS AND REVIEW ALLEGED PROBLEMS OF COMPLIANCE BASED ON AN IRS STUDY OF QUESTIONABLE DATA. THE IRS "SURVEY" WAS BASED ON THE EXAMINATION OF A NUMBER OF RETURNS FILED BY INDEPENDENT CONTRACTORS THAT HAD ALREADY BEEN FLAGGED AS "DISPUTED" AND WERE AT THAT TIME UNDER "EXAMINATION." THE FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, MR. DONALD C. LUBICK, IN HIS JUNE 20, 1979 TESTIMONY BEFORE THE SELECT REVENUE SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE, CITED THE BASIS FOR THE IRS STUDY:

> "THE STUDY FOCUSED SPECIFICALLY ON INDUSTRIES IN WHICH DISPUTES BETWEEN TAXPAYERS AND THE IRS AS TO THE EMPLOYMENT STATUS OF WORKERS HAVE FREQUENTLY ARISEN. TO BEGIN WITH, A LIST OF THE WORKERS FROM ALL OPEN EXAMINATION CASES INVOLVING THE EMPLOYEE-INDEPENDENT CONTRACTOR ISSUE WAS OBTAINED."

THE CONCLUSIONS THAT WERE DRAWN BY THE IRS FROM THESE "DISPUTED" CASES DEMONSTRATE ONLY THAT NOT ALL OF THE DISPUTED CASES WERE THE RESULT OF NON-COMPLIANCE. THEIR CONCLUSIONS REPRESENT ONLY THE NUMBER OF VIOLATIONS IN THE DISPUTED CLASS, A VERY SMALL, SELECT GROUP AMONG THE FOUR MILLION INDEPENDENT CONTRACTORS IN THE UNITED STATES. THE IRS HAS NEVER CONDUCTED A STUDY OF ALL INDEPENDENT CONTRACTORS. THEY HAVE ELECTED TO PASS JUDGMENT ON MILLIONS OF BUSINESS PEOPLE ON THE BASIS OF FAULTY AND MISLEADING DATA.

WE ARE BACK AGAIN, THREE YEARS LATER, REVIEWING THE ISSUES RAISED IN THE SAME IRS STUDY WHICH HAS BEEN PROVEN FAULTY. THE IRS HAS

PRESENTED NO NEW STUDY.

WE BELIEVE THAT THE VAST MAJORITY OF AMWAY DISTRIBUTORS ARE RESPONSIBLE CITIZENS WHO ARE ACCOUNTING FOR ALL OF THEIR INCOME ON THEIR INCOME TAX RETURNS AND ARE CLAIMING ONLY THOSE DEDUCTIONS WHICH ARE PERMITTED UNDER THE INTERNAL REVENUE CODE.

WE BELIEVE, FURTHERMORE, THAT THIS COMMITTEE SHOULD BEGIN TO ADDRESS THE COMPLEXITY OF THE PRESENT TAX CODE. MORE AND MORE, AMERICANS ARE HAVING TO RELY UPON TAX ADVISORS AND PREPARERS. BECAUSE OF THE COMPLEXITY AND AMBIGUITY OF THE TAX CODE, A SMALL BUSINESS PERSON SUCH AS AN AMWAY DISTRIBUTOR CANNOT FULLY UNDERSTAND HIS TAX LIABILITIES AND IS THEREFORE COMPLETELY DEPENDENT ON A TAX ADVISOR. A SIMPLER CODE WOULD ALLOW THE AMERICAN TAXPAYER TO FULLY UNDERSTAND HIS RESPONSIBILITIES.

I WOULD LIKE AT THIS TIME TO ADDRESS "S 2369 - THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982." WE COMMEND SENATOR DOLE AND THE COSPONSORS FOR A VERY COMPREHENSIVE BILL ON THE INDEPENDENT CONTRACTOR ISSUE. WE WOULD LIKE TO SUPPORT THIS BILL, BUT WE HAVE SEVERAL MAJOR CONCERNS IN THE AREAS OF DIRECT SELLING REPORTING AND PENALTIES.

FIRST, WE SUPPORT THE SAFE HARBOR MEASURE OF S 2369, WHICH PROVIDES A STATUTORY DEFINITION OF "INDEPENDENT CONTRACTOR." WE AGREE THAT THERE IS A NEED TO RETAIN THE COMMON LAW DEFINITION TO PROTECT THE TRADITIONAL INDEPENDENT CONTRACTOR IN OUR INDUSTRY AND TO PROVIDE A GUIDELINE FOR NEW INDUSTRIES OF THE FUTURE. THE "SAFE HARBOR"

TEST AND THE COMMON LAW DEFINITION ARE CONSISTENT WITH THE GOALS OF OUR FREE ENTERPRISE SYSTEM IN WHICH EVERYONE HAS THE OPPORTUNITY TO BECOME AN ENTREPRENEUR.

NOW, I WOULD LIKE TO ADDRESS SECTION THREE OF S 2369 -- THE "INFORMATION REPORTING REQUIREMENTS OF REMITTANCES FOR SERVICES AND DIRECT SALES." I UNDERSTAND THE COMPLEXITIES OF TRYING TO ESTABLISH A REPORTING SYSTEM FOR AN INDUSTRY IN WHICH EVERY COMPANY DIFFERS FROM THE OTHER. BUT, AS I MENTIONED EARLIER, WE ARE CONCERNED WITH THE COMPLEXITIES OF THE TAX CODE. WE ARE ALSO CONCERNED ABOUT THE ADDITIONAL COST AND BURDEN THAT WILL RESULT FROM SOME OF THESE MEASURES, AND FROM WHICH NO ADDITIONAL REVENUE OR USEFUL AND MEANINGFUL INFORMATION WILL BE REALIZED.

LET ME STATE HERE THAT, AS FAR AS S 2369 IS CONCERNED, AMWAY CORPORATION CAN MEET THE ALTERNATIVE REPORTING REQUIREMENT AS OUTLINED IN THE BILL, BECAUSE AMWAY HAS FOR YEARS DISTRIBUTED FORMS 1099 TO EACH AND EVERY DISTRIBUTOR WITH WHOM IT DIRECTLY DOES BUSINESS, NAMELY OUR DIRECT DISTRIBUTORS. UNDER THE CURRENT LAW, A 1099 FORM NEEDS TO BE ISSUED TO THOSE PERSONS TO WHOM WE HAVE PAID A BONUS OF $600 OR MORE PER YEAR. IN FACT, WE ISSUE SUCH A 1099 FORM TO ALL DIRECT DISTRIBUTORS, REGARDLESS OF THE AMOUNT OF THEIR BONUES, EVEN DOWN TO $1.00. IN ADDITION, AS REQUIRED BY THE CODE, AMWAY FILES WITH THE IRS A FORM 1096 WHICH CONTAINS A SUMMARY OF ALL THE 1099 INFORMATION. AS YOU CAN SEE, UNDER THE BILL, WE WOULD ALREADY BE DOING MORE THAN WHAT IS REQUIRED.

OUR CONCERN DOES NOT RELATE TO AMWAY CORPORATION ITSELF BUT RATHER

TO THE IMPACT UPON THE HUNDREDS OF THOUSANDS OF AMWAY DISTRIBUTORS WHO WILL BE AFFECTED. AS I MENTIONED EARLIER, AMWAY CORPORATION DOES NOT DEAL DIRECTLY WITH THE MAJORITY OF AMWAY DISTRIBUTORS. THEREFORE, IT IS OUR WISH TO KEEP THE REPORTING REQUIREMENTS FOR DISTRIBUTORS AS SIMPLE AS POSSIBLE.

ONE OF THE OPTIONS OF THE PREPARED BILL WOULD REQUIRE THAT INDEPENDENT CONTRACTORS REPORT TO THE IRS ANNUALLY THE AMOUNT OF GROSS SALES OVER $5,000 MADE FOR RESALE PURPOSES AND THE AMOUNT OF REMITTANCES OVER $600. REPORTING OF GROSS SALES IN THE CASE OF AMWAY DOES NOT PROVIDE THE IRS WITH THE INFORMATION NEEDED TO ESTABLISH EXACTLY THE AMOUNT OF TAXABLE INCOME EARNED. A GROSS SALES FIGURE DOES NOT REPRESENT INCOME EARNED. FOR AMWAY DISTRIBUTORS, THE PRODUCT WHICH IS PURCHASED EITHER FROM THE COMPANY OR FROM AN UPLINE DISTRIBUTOR IS USED IN ONE OF THREE WAYS: (1) FOR HIS OWN RETAIL SALES TO HIS CUSTOMERS; (2) FOR SALE, AT WHOLESALE, TO THE DISTRIBUTORS HE HAS PERSONALLY SPONSORED WHICH USUALLY ACCOUNTS FOR THE MAJORITY OF HIS SALES; AND (3) FOR HIS PERSONAL AND FAMILY USE.

AS YOU CAN SEE FROM THE FOREGOING, REPORTING GROSS SALES IS NOT REALLY APPROPRIATE FOR THE AMWAY SYSTEM -- EVEN THOUGH WE UNDERSTAND THAT, UNDER SOME DIRECT SELLING PLANS, SUCH REPORTING MAY BE THE BEST METHOD FOR GAINING INFORMATION FOR THE IRS.

AMWAY INDEPENDENT DISTRIBUTORS RECEIVE BONUS PAYMENTS ON THEIR GROSS SALES. THE AMOUNT OF SUCH BONUS PAYMENTS PROVIDES A

MORE REALISTIC BASIS FOR TAXABLE INCOME THAN SALES MADE. THEREFORE, AMWAY DELIEVES THAT LOWERING THE $600 THRESHOLD FOR 1099 FORMS WOULD PROVIDE IRS WITH THE KIND OF INFORMATION THAT WOULD BE MOST USEFUL TO IT.

WE DO ACCEPT THE ALTERNATIVE REPORTING PROVISION OF S 2369, BUT WITH ONE MAJOR CONCERN. WE SUPPORT LOWERING THE THRESHOLD OF THE 1099 FORM TO $50, OR EVEN LOWER, BUT WE BELIEVE THAT THE PROVISION REQUIRING DISTRIBUTORS TO FILE BLANK 1099'S FOR ALL PEOPLE WHO RECEIVE LESS THAN $50 BONUSES, BUT WHO PURCHASE MORE THAN $50 OF PRODUCT IN A YEAR FOR RESALE, IS UNJUSTIFIABLE. THIS REQUIREMENT ADDS A TREMENDOUS BURDEN OF PAPERWORK NOT ONLY UPON THE AMWAY DISTRIBUTOR FORCE, BUT UPON THE HUNDREDS OF THOUSANDS OF OTHER INDEPENDENT DIRECT SELLERS IN OUR INDUSTRY. COMPLIANCE WITH THIS REQUIREMENT GIVES THE IRS LITTLE OR NO USEFUL INFORMATION AS TO THE DISTRIBUTORS' TAX LIABILITIES.

THE PURCHASE OF $50 WORTH OF PRODUCT IS A VERY UNREALISTIC THRESHOLD BY WHICH TO DETERMINE WHETHER SOMEONE IS IN BUSINESS TO GENERATE A PROFIT. AS A MATTER OF FACT, SINCE YOUR PRODUCT SALES KIT COSTS MORE THAN $50, ANYONE WHO PURCHASED ONE WOULD BE COVERED BY A 1099 FORM EVEN THOUGH HE CONDUCTED NO BUSINESS WHATSOEVER. UNDER OUR SYSTEM, THE DISTRIBUTOR FILING A 1099 FORM ON ANOTHER DISTRIBUTOR HAS NO KNOWLEDGE AS TO HOW MUCH OF THE PRODUCT, IF ANY, WAS BOUGHT FROM HIM FOR RESALE. THIS WILL ADD TO WHAT IS ALREADY AN ENORMOUS AMOUNT OF PAPER AND FORMS FOR THE IRS, WHICH ALREADY RECEIVED MORE THAN IT CAN HANDLE, AND WILL NOT PROVIDE THE IRS WITH USEFUL INFORMATION.

I PERSONALLY FEEL IT WOULD BE BETTER TO LOWER THE 1099 THRESHOLD AND ELIMINATE THE $50 GROSS SALES REPORTING REQUIREMENT. HOWEVER, IF THE COMMITTEE WISHES TO RETAIN A GROSS SALES REQUIREMENT, A MORE REALISTIC FIGURE WOULD BE $1,500 OF PRODUCT PURCHASED ON AN ANNUAL BASIS, WHICH AMOUNTS TO $125 PER MONTH.

ANOTHER AREA OF CONCERN IS THE PENALTIES SECTION. ALTHOUGH WE STRONGLY SUPPORT THE NEED FOR INCREASED PENALTIES, WE RECOMMEND THAT THE COMMITTEE REVIEW THE SEVERITY OF SOME OF THESE PENALTIES. FOR EXAMPLE, THE PENALTIES FOR THE FAILURE TO PROVIDE A 1099 TO THE PAYEE AND A COPY TO IRS WOULD RESULT IN PENALTIES EQUAL TO 30% OF THE AMOUNT OF COMPENSATION WHICH IS SUBJECT TO REPORTING. WE SUBMIT THAT THIS IS AN UNUSUALLY SEVERE PENALTY, PARTICULARLY IN THE CASE OF FIRST OFFENDERS.

PERHAPS YOU MAY WISH TO CONSIDER SOME TYPE OF FIXED DOLLAR LIMIT FOR FIRST OFFENDERS, AS WELL AS STRENGTHENING THE "REASONABLE CAUSE" PROVISION.

FINALLY, MAY I RECOMMEND TWO ADDITIONAL MEASURES WHICH COULD BE TAKEN BY THIS COMMITTEE TO HELP ENCOURAGE THE REPORTING OF INCOME BY SELF-EMPLOYED INDIVIDUALS:

FIRST, ADD A CHECK-OFF BOX TO THE FORM 1040 IN WHICH THE TAXPAYER IS TO DESIGNATE WHETHER HE HAS EARNED INCOME FROM SELF-EMPLOYEMENT DURING THE TAX YEAR. THIS FEATURE WOULD FOLLOW THE PRECEDENT ESTABLISHED BY THE IRS IN OTHER COMPLIANCE AREAS.

SECOND, REQUIRE THAT A COPY OF THE FORM 1099 BE ATTACHED TO THE FORM 1040 IN THE SAME MANNER AS A W-2 FORM IS ATTACHED.

IN CONCLUSION, I WOULD LIKE TO THANK THE COMMITTEE FOR THIS OPPORTUNITY TO DISCUSS THESE ISSUES WHICH ARE IMPORTANT NOT ONLY TO AMWAY CORPORATION, BUT ALSO TO THE 750,000 INDEPENDENT AMWAY DISTRIBUTORSHIPS, NATIONWIDE.

WE FULLY RECOGNIZE OUR RESPONSIBILITY, AS AMERICAN CITIZENS, TO PAY OUR FAIR SHARE OF TAXES. WE SUPPORT YOUR EFFORTS TO SEE THAT ALL INDEPENDENT CONTRACTORS PAY THEIR FAIR SHARE OF TAXES. THEREFORE, WE WOULD BE WILLING TO SUPPORT S 2369 IF IT EITHER ELIMINATES THE $50 GROSS SALES REPORTING THE ALTERNATIVE, OR RAISES THE GROSS SALES FIGURE TO $1500 ANNUALLY.

I WILL BE HAPPY TO ANSWER ANY QUESTIONS YOU MAY HAVE. THANK YOU.

Senator GRASSLEY. Mr. Gibbons.

STATEMENT OF JAMES J. GIBBONS, PRESIDENT, MANUFACTURERS AGENTS NATIONAL ASSOCIATION, IRVINE, CALIF., ON BEHALF OF THE ASSOCIATION AND ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL, WASHINGTON, D.C.

Mr. GIBBONS. Thank you. I am the president of Manufacturers Agents National Association. I am also the vice chairman of the Small Business Legislative Council, which is a coalition of 70 small business trade and professional groups on whose behalf this testimony is presented. You have my testimony; I will just summarize.

MANA is the national professional association for independent manufacturers' representatives and their principals. And all of this association's regular members are independent contractors, 80 percent of which are corporations. They are independent, certainly. They are single, multiman manufacturers' agencies contracting simultaneously with several manufacturers to offer a sales and marketing service in a predetermined, exclusive territory. A manufacturers' agent does not buy and resell the products of the manufacturers he represents. He takes no title to the goods. His remuneration consists solely of commissions received on the dollar volume of goods shipped into his territory—a gross revenue out of which come all of the business operating expenses, including payroll taxes.

MANA and SBLC are on record as favoring the adoption of a statutory definition of independent contractor status in the form of the five-point safe harbor test. We, therefore, support Senator Dole's bill, S. 2369, not only for the five point definition of independent contractors, a definition which applies most appropriately to manufacturers' agents, but also for the Dole bill's measures to insure compliance of existing payroll tax laws.

It is MANA's view that the existing reporting system can meet the needs of the IRS in monitoring payments to independent contractors if all pertinent information is supplied by independent contractors and those utilizing their services. We think S. 2369 will insure proper information reporting and aid efforts to improve compliance without imposing additional taxes or unusually heavy reporting requirements. The 1099 system certainly seems to work well for us.

Thank you. I will answer any questions.

[The prepared statement of James J. Gibbons follows:]

STATEMENT OF
JAMES J. GIBBONS
BEFORE THE
SENATE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
HOLDING HEARINGS ON
S. 2369

Mr. Chairman and Members of the Subcommittee:

My name is James J. Gibbons, and I am president of Irvine, California-based Manufacturers' Agents National Association (MANA), the national professional association of independent manufacturers' representatives and their principals. Founded in 1947, MANA is the longest-established and most broadly-based manufacturers' representatives organization in the country. All of the Association's regular members are independent contractors -- independent manufacturers' agencies contracting with manufacturers on an individual basis to offer a sales and marketing service in a predetermined territory. Their compensation consists solely of commissions received on goods shipped into their territories -- an amount out of which comes all business operating expenses, including travel, rents, capital expenditures, staff salaries and payroll taxes. They serve virtually every industry and are widely recognized as the most efficient and cost-effective marketing method known.

I am appearing here today in my capacity as vice chairman of the Executive Committee of the Small Business Legislative Council (SBLC), a coalition of 70 small business trade and professional groups. Accompanying me is Jerome Gulan, SBLC's legislative director.

The SBLC's member associations have adopted the position, long maintained by MANA, that as an integral part of the small business community, the independent contractor must be accorded the assurance that his independent status will be protected by law. We therefore take this opportunity to voice our continued support for legislation that will clarify the employment status of independent contractors, while at the same time ensuring compliance with the provisions of the Tax Code. The approach taken by Senator Dole and the cosponsors of S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982, is one which we support, and one which we urge this subcommittee to favorably consider.

Past congressional action on this issue has consisted only of temporary measures designed to stay further audits of independent contractors and their payors by the IRS. And while these actions have symptomatically treated the problem, the fact remains that there is a significant segment of the business community now operating under ambiguous standards for determination of their employment status. Since Congress first acted on the independent contractor issue through adoption of Section 530 of the Revenue Act of 1978 (PL 95-600), MANA has supported enactment of a statutory test for determination of independent status -- the five-point safe harbor test.

At hearings before a House subcommittee in July, 1979, I testified that independent contractors need a "workable and definitive" set of standards to define their status, and that continued uncertainty in this area would have a "negative impact" on those industries utilizing the services of independents. In our view, bills such as H.R. 3245 and S. 736 of the 96th Congress addressed the issue directly: an independent contractor (1) controls the number of hours worked; (2) is not provided with a place of business by the service recipient; (3) has a substantial investment in capital assets and risks income fluctuation based on sales or other output; (4) performs the service under the terms of a written agreement outlining a specific independent contractor/payor relationship; and (5) performs services for a recipient who files all reporting forms as required by Section 6041(A) of the Tax Code.

Our support for this safe-harbor approach -- and our support for S. 2369 -- is based on our position that independent manufacturers' representatives and the manufacturers they represent must be able to operate with a degree of certainty that their independent contractor/principal relationship will not come under repeated scrutiny by the Internal Revenue Service. The five-point test provides that certainty, for manufacturers' agents do control their own hours; their services are not performed in a single, fixed location, nor are their offices provided by their principals; they have a substantial investment in the tools of their trade, and they perform all services under the terms of a written agreement. The manufacturers they represent also conform to the safe-harbor provisions through the 1099 payment reporting system.

Our support for the Dole bill goes beyond the five points of the independent contractor test, however. The proposed legislation also provides new measures to improve compliance among independent contractors and their payors without imposing an across-the-board automatic and mandatory withholding from payments made to them. The Carter Administration proposed such a move, and it was immediately opposed by independent contractor groups such as MANA and other member associations of the Small Business Legislative Council. It was our view then, as it is now, that manufacturers' agents and the manufacturers they represent are in full compliance with payroll tax requirements through the provisions of the existing 1099 system, and to subject an agency's commissions to a 10-percent withholding would not only jeopardize an agent's business operations, but would also be burdensome to those manufacturers using the services of manufacturers' representatives. For agents, that 10-percent of gross commission receipts often represents his only discretionary income -- his company's net profit. For manufacturers, the additional recordkeeping requirements imposed on manufacturers would have deterred them from using agents in their marketing plans, and it would have the effect of placing manufacturing firms in the position of monitoring compliance and collecting taxes for the Internal Revenue Service.

MANA and the Small Business Legislative Council remain unalterably opposed to mandatory withholding provisions, and we're happy to note that except in those cases where an independent contractor refuses to voluntarily supply information to the service recipient, that S. 2369 has abandoned this coercive approach to payroll tax compliance. We reiterate our continuing support for passage of a statutory definition of independent contractors, and our strong support for efforts to ensure compliance through use of the reporting mechanisms now in place. The 1099 system was established to provide the IRS with the information it needs to monitor tax payments. If that system is somehow deficient, then remedies to correct it must be enacted. But Congress must first ensure that the tax reporting systems currently in place are reliable before seeking to impose additional taxes on those who are already in compliance with the law.

Taxpayer noncompliance is a serious matter, and we applaud the efforts of the Reagan Administration and this subcommittee to tighten enforcement procedures so the billions of dollars now lost through underreporting can be recovered. We support S. 2369 and its safe-harbor independent contractor test, and we urge this body to adopt this bill's approach and end the uncertainty over this issue which has lingered since 1978.

Senator **GRASSLEY**. Jay, what's the difference between the $1,500 reporting threshold versus the $50 threshold in the number of people you would have to report?

Mr. **VAN ANDEL**. I'd say at least half a million people. And the other thing is that system of reporting is all manual so the IRS would get a whole lot of pieces of paper that they would have to handle manually. If they wanted to do anything with it, it would all have to be entered into a computer. And I think you are talking about an expenditure that probably would be greater than any returns from it. Whereas on the 1040, you know, it is already there. And they would be processing that by machine as it comes in.

Senator **GRASSLEY**. I asked another panel this question. Suppose we can't get the bill passed—I don't think there is any reason to think we can't—do you support another short moratorium?

Mr. **VAN ANDEL**. I think a moratorium would be absolutely necessary if you can't get the bill passed.

Mr. **MCNEER**. We would also support that, Mr. Chairman.

Mr. **GIBBONS**. And we would do the same.

Senator **GRASSLEY**. Can you offer any suggestions on ways to solve the problem of retroactive reclassification of employees, especially as it pertains to Keogh and other pension plans?

Mr. **VAN ANDEL**. I have no comment on that.

Mr. **Gibbons**. I haven't either.

Mr. **McNeer**. I would suppose, Mr. Chairman, some of that will have to come out in the wash. There will probably have to be some reclassification as there would be in anything. But I would think it would come out in the wash.

Senator **Grassley**. Maybe what you could do then is think about it, and submit something to us in writing. We would appreciate it.

Mr. **Gibbons**. Considering the fact that our people represent not 1 but as many as 8 or 10 different principals, I think the 1099 form is the only possible way. I see no reason for any kind of reclassification. So I hadn't even thought about it.

Senator **Grassley**. Senator Dole.

Senator **Dole**. Well, I think some of the suggestions probably can be accommodated. We will have to take a look at those and see where we come out. I'm not certain I understand, but apparently the staff does so I will ask Mr. Van Andel a question. Could one way to improve taxpayer compliance and also relieve the burden on your lower tiered distributors be for the top tier, Amway itself, to voluntarily file identifying 1099's for the complete Amway sales force? You could do it with magnetic tape, which would help the IRS. Is that feasible for Amway?

Mr. **Van Andel**. Well, I think for IRS to ask any private company to turn in its private mailing list, as such, is going to be not very acceptable. As I have said, I think the IRS can get what they want from a checkoff box on the 1040, if they want to know who's an independent contractor, who's in a business of some kind.

Senator **Dole**. I haven't explored the checkoff. I'm not certain—I assume most people who are independent contractors would know it. We have been trying to clarify that for 20 years. They may not know which box to check. Are you an independent contractor? Check here. I guess you could define what you meant by independent contractor.

Mr. **Van Andel**. Or you would say, "Do you have any self-employed income?" You put the words in some way. And I think, Senator, that most responsible companies in the business have made quite an effort to inform their salespeople or their distributors or whatever as to what they are supposed to do regarding taxes. I know we do that every year. In January, we publish a bulletin that goes to everyone on how you pay your taxes, and what you are supposed to do, and what you are not supposed to do, and that sort of thing. And we intensify that if there are special problems. In fact, I have discussed that with Mr. Egger of the IRS, and suggested that perhaps they should more often go to the companies as a means of communication to these people because we already have lines of communication. And we also have credibility with these people. And they tend to do what we tell them. So if the IRS used that route for communication, I think we can get the compliance.

I think the compliance really, among independent contractors, is much higher than some people think it is. I really think, again, that the majority of the people in this country do pay their taxes properly. It's unfortunate that we have a terribly complex tax law so that small business people, very often, don't understand how to do it. And they have to go to advisers. And sometimes you get bad advice. That's all part of the edifice that we have built. But I think that they are getting considerable help certainly from the larger direct selling companies. And that covers most of the people. Most of the salespeople in the direct selling business are probably covered by 8 or 10 companies.

Senator DOLE. I think you are correct. And, hopefully, if we ever resolve some of the other problems in the tax area, we are going to address simplification. I don't think we need to indicate we are because everybody else has and it has never happened. We thought we would wait until we finish some of the other areas and then get all kinds of ideas on how to fix up the Tax Code. We get them daily in the mail. No deductions, no exemptions, 10 percent, 12 percent. I'm afraid you wouldn't be able to get a room between here and New York City if we started some of those hearings. But maybe eventually we will.

Mr. VAN ANDEL. Good luck.

Senator DOLE. There would be a lot of lobbyists in town. We like lobbyists, but we don't have room for them at home. [Laughter.]

Senator GRASSLEY. Mr. McNeer, I'm not sure that I fully appreciated the problem unique in your testimony about traveling or city salesmen. But if I did, are you fearful that with the package of the Dole bill that in your relationship with the IRS you might be put in a worse position than you are today?

Mr. MCNEER. This is the feeling of our association. The problem, as we see it, is the new bill very likely would force many firms to go back and use the common law regulations to try and determine the status of their people. And rather than to classify them as employees, which we are very sure that they wouldn't be, they will go back and use this other classification or be forced to classify them as employees. And there are very, very independent people in our association and in our industry who do not want to be classified as employees. They are law-abiding, fine people. But they operate on their own. They have their own hours. They have their own place of work and so forth. And so it seems to us a very, very important thing that the language in S. 8 be restated in the new bill.

And, furthermore, as far as the classification for the traveling or city salesman is concerned, it is such a vague, complicated situation that it is almost impossible for small firms to determine what kind of an animal this traveling or city salesman is. They are—from what I understand—supposed to devote the bulk of their time to one firm, with the majority of that being contact with wholesalers and retailers, restaurants and hotels, and this type of trade. And it would be a tremendous task for any firm to try and determine what amount of time these individuals put with that type of contact. It is an animal that would be very, very difficult to live with. And for those reasons, we feel it would take a lot of the complexities out of it to use the same language as was in S. 8, which, again, is giving the same status to the traveling or city salesman as the others.

Senator GRASSLEY. Did you have something?

Mr. OLSON. If I might, Mr. Chairman. We are particularly concerned with the language of section 3121(d) as it relates to defining a traveling or city salesman. Now our independent contractors sell to everyone in the community. And by definition, if you sell to a wholesaler or retailer or contractor, hotel, or restaurant, you are in one category. But our companies will then have to determine with their independent contractor. If he sells to a bank, then he is in one category. If he sells to a manufacturer, he is not in that category and so forth. And we are in a small business industry. And we see this as a horrendous amount of additional paperwork. And if we stay with the definition in the safe harbor tests, as is outlined in S. 8, we won't have this problem.

Senator **Grassley**. This can't be something that's just unique and special to the average guy.

Mr. **Olson**. Absolutely not.

Mr. **McNeer**. I think for that reason we are stating this on behalf of many firms that are in this similar situation that would have an animal that they just wouldn't know how to work with. There are traveling and city salesmen, I am sure, in our industry as there are in others. But even the classification of them seems like, in this day and age, such a strange classification. In most instances, I think they would rather be classified as employees or as independent contractors. Those two statuses.

Senator **Grassley**. I want to thank all of you on this panel for your contributions. Thank you very much.

Senator **Dole**. I think we may be able to work part of that problem out. So there will be contact with Senator Grassley's staff.

Senator **Grassley**. The last panel for the afternoon is a panel consisting of Grace Ellen Rice, assistant director, national affairs division, American Farm Bureau Federation; Mr. Stephen Koplan, legislative representative, department of legislation, American Federation of Labor and Congress of Industrial Organizations; and Dr. Jerald R. Schenken, member of the American Medical Association Council on Legislation, Omaha, Nebr., on behalf of the AMA, with offices in Washington, D.C.

I would ask Grace Ellen to start first.

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION, WASHINGTON, D.C.

Ms. **Rice**. Yes, sir. Mr. Chairman, the American Farm Bureau Federation is the Nation's largest farm organization. We represent approximately 3 million member families throughout 48 States and Puerto Rico.

At the 62d annual meeting of the American Farm Bureau Federation, our voting delegates adopted the following policy statement.

> During the last several years, the Internal Revenue Service has attempted to change several taxpayer classifications from independent contractor to employee. This group includes custom harvesters, carpenters, truck drivers, insurance agents, realtors, and other individuals traditionally considered independent contractors.
>
> Congress has acted to continue the present definition of independent contractors through June 30, 1982. We recommend that the present independent contractor status of the affected individuals be preserved.

And it's to this policy that we address the bill in question today. Farmers often use the services of individuals traditionally classified as independent contractors whether they are retained for agricultural services or transportation services during planting or harvesting of crops and timber. They control their own working schedule, own and maintain their own equipment, and determine the most appropriate means for performing the task for which they are contracted. To attempt to classify these individuals as employees is an unfair administrative and financial burden to farmers who retain their services.

While independent contractors often provide direct agricultural services to farmers and ranchers, the Farm Bureau offers its members other economic services such as property, casualty, and life insurance. The insurance sales activities are provided by insurance agents, traditionally considered independent contractors, who control their own working hours, have no principal place of business and who risk fluctuations in income based upon their own initiatives. The efforts of the Internal Revenue Service to reclassify these independent business people as employees rather than independent contractors is unwarranted. A change in the classification of individuals who are now classified as independent contractors could have serious consequences on the operations of farmer-owned insurance companies and thus work to the detriment of the farmers and ranchers whose businesses are insured through these companies.

The Farm Bureau wishes to give its support today to S. 2369, introduced by Senator Robert Dole. The bill provides objective standards to determine whether an individual is an independent contractor or an employee. Provisions relating to control of hours, place of business, investment or income fluctuation, contract and notice, and filing provide clear guidance. In addition, we believe the no inference clause is important to assure that all individuals who have traditionally been considered independent contractors will continue to be treated as such for Federal tax purposes. The bill promotes a clear definition of who qualifies as an independent contractor.

There is only one point in this bill with which we are concerned. The penalty provisions may be unduly harsh for the occasional user of independent contractors' services who inadvertently fails to file an information return or files a late return. For this reason, we would urge that the Internal Revenue Service provide clear guidelines to both the contractor and to the service recipient on the issue of independent contractors.

We do appreciate the need for tax compliance, but we want the Internal Revenue Service to be reasonable in determining what the reasonable cause will be for failure to file a return or to file it promptly. We believe that this is particularly an appropriate comment for the Subcommittee on Oversight of the Internal Revenue Service to consider today.

We do support this legislation. We ask that our statement be submitted for the hearing record and would be glad to answer any questions.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SENATE FINANCE COMMITTEE RELATING TO THE STATUS OF INDEPENDENT CONTRACTORS

Presented by
Grace Ellen Rice, Assistant Director of the National Affairs Division

April 26, 1982

The American Farm Bureau Federation is the nation's largest general farm organization representing over three million families in 48 states and Puerto Rico. Farm Bureau is a voluntary, nongovernmental organization whose policy is developed by Farm Bureau members at the county, state, and national levels.

At the 62nd annual meeting of the American Farm Bureau Federation, voting delegates of the member State Farm Bureaus adopted the following policy with regard to the classification of independent contractors and employees:

> "During the last several years the Internal Revenue Service has attempted to change several taxpayer classifications from independent contractor to employee. This group includes custom harvesters, carpenters, truck drivers, insurance agents, realtors, and other individuals traditionally considered independent contractors.
>
> "Congress has acted to continue the present definition of independent contractors through June 30, 1982. We recommend that the present independent contractor status of the affected individual be preserved."

Farm Bureau commends the Subcommittee for holding hearings on legislative proposals concerning the status of independent contractors. The audit campaign of the Internal Revenue Service has been a burden to individuals who must defend their status as independent contractors and those who retain the services of independent contractors. While Farm Bureau supports the current moratorium on Internal Revenue Service regulatory activity with regard to independent contractors, we believe that Congress should act now to clarify the definition and tax status of independent contractors.

Farmers often use the services of individuals traditionally classified as independent contractors. Independent contractors provide agricultural services during the planting and harvesting of crops and timber. They control their working schedules, own and maintain their equipment, and determine the most appropriate means for performing the task for which they are contracted. To attempt to classify these individuals as employees is an unfair administrative and financial burden to farmers who retain their services.

While independent contractors often provide direct agricultural services to farmers and ranchers, Farm Bureau offers its members economic services such as property, casualty, and life insurance. The insurance sales activities are provided by insurance agents, traditionally considered independent contractors, who control their own working hours, have no principal place of business and who risk flucuations in income based upon their own initiative. The efforts of the IRS to reclassify these independent business people as employees, rather than independent contractors, is unwarranted. A change in the classification of individuals who are now classified as independent contractors could have serious consequences on the operations of farmer-owned insurance companies and thus work to the detriment of farmers and ranchers whose businesses are insured through these companies.

Farm Bureau supports legislation such as S. 2369 introduced by Senator Robert Dole. The bill provides objective standards to determine whether an individual is an independent contractor or employee. Provisions relating to control of hours, place of business, investment or income flucuation, contract and notice, and filing provide clear guidance. In addition, we believe that the "no inference" clause is important to assure that all individuals who traditionally have been considered independent contractors will continue to be treated as such for federal tax purposes. Although the more comprehensive reporting and contract requirements of S. 2369 may cause more administrative effort by independent contractors and their service recipients, the bill does promote a clear definition of who qualifies as an independent contractor. We are concerned, however, that the penalty provisions may be unduly harsh for the occasional user of an independent contractor's services who inadvertently fails to file an information return. Farm Bureau policy also urges Congress to increase the reporting level for information returns (Form 1099) from $600 to $5,000. We urge the Subcommittee to modify S. 2369 to reflect the higher threshold amount before the information return is required.

We urge the Subcommittee to approve S. 2369 and to consider a modification to increase the reporting level. Farm Bureau asks that Congress act promptly to clarify standards for determining independent contractor status. The moratorium has provided temporary relief, but a permanent solution must be enacted.

Thank you.

Senator GRASSLEY. Mr. Koplan.

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, WASHINGTON, D.C.

Mr. KOPLAN. Thank you, Mr. Chairman.

Mr. Chairman, I won't read my full statement, but I would ask that it be reproduced in its entirety in the hearing record.

Senator GRASSLEY. I might say that is true for all the statements. They will be made a part of the record.

Mr. KOPLAN. Thank you.

Mr. Chairman, the AFL-CIO appreciates this opportunity to present its views on efforts to develop legislation which would assure that employers and independent contractors pay their fair share of taxes. We urge this subcommittee to narrowly limit the use of independent contractor status so that employers will be discouraged from circumventing their responsibilities in contributing to the exploitation of workers.

Apart from the tax equity issue, the AFL-CIO is concerned that the final version of the bill could serve as a means for unscrupulous employers to manipulate the form of employees' work relationships so as to benefit by having those employees classified as independent contractors.

Unless such machinations are prevented, employees will find themselves reclassified and excluded from job protections they now enjoy.

My prepared statement sets forth a series of examples of such protections. In order to conserve time, I won't read those examples into the record.

Mr. Chairman, American workers and their families have a vital interest in the final outcome of these hearings that far transcends tax considerations. At the same time, we applaud the stated intent of this subcommittee to secure tax compliance. The enormity of noncompliance in this area is shocking. In the last Congress, the Treasury Department testimony disclosed that at least 47 percent of workers classified as independent contractors did not report any of the compensation paid to them. At that time, the annual revenue loss from such noncompliance was conservatively estimated by the Treasury at $1 billion, about two-thirds of which is income taxes, and about one-third of which is payments for the social security fund.

In order to capture the lost revenue, promote tax equity, and resolve the classification problem, we urge that the existing system for withholding on employees at graduated rates be expanded to independent contractors, and clear-cut classification criteria be developed. Specifically, the common law test should be replaced with one that will narrow the category of those workers who now marginally fall into the status of an independent contractor. At present, there are 20 common law factors used to determine whether an employee or employer relationship exists. This leaves the door open to inconsistent interpretation of the common law rules governing employment status.

In 1979, the AFL–CIO endorsed criteria along the lines of those suggested by the Treasury Department at that time as a means to solve the definitional problem of independent contractors, and minimize the opportunity for abuse. The suggested criteria were as follows:

If a worker had a substantial investment in assets other than transportation vehicles used in a nontransportation business; employees of his or her own who provided a substantial portion of the services for which compensation is received; substantial, continuing expenses and concurrently performed services for more than one payor; and a separate place of business other than a home office.

If such criteria were not met, we recommended that the individual be classified as an employee for tax purposes.

We still believe that the preferred course of action to assure tax compliance and protection of workers is to provide for graduated withholding for independent contractors, and adopt clear-cut classification criteria such as those suggested by the Treasury 3 years ago.

If the subcommittee does not choose to follow that course of action, at the least, we recommend that favorable consideration be given to the concept embraced in H.R. 5867. That proposal contains safe harbor rules developed in the last Congress that intended to strike a delicate balance in the midst of controversy over classification standards. While we would seek to improve H.R. 5867, we urge that this subcommittee examine its provisions as a useful starting point for deliberation.

S. 2369, introduced by you, Chairman Dole, on April 14th includes provisions for improved information reporting on payments by service recipients to independent contractors. We recognize that it would serve, to some extent, to improve compliance. Unfortunately, it has been established that there is over 40 percent noncompliance by the payors in the filing of informational—forms 1099—returns as compared to extremely minimal noncompliance with employers in filing withholding form W-2. To quote past Treasury Department testimony, "information reporting can never replace withholding as a means of achieving satisfactory compliance."

Finally, we note that when S. 2369 was introduced Chairman Dole invited comments regarding procedural issues in tax audits. In that regard, we recommend that any safe harbor test should, by its terms, be inapplicable to any workers who are actually being treated by the employer as employees under the National Labor Relations Act or under the unemployment compensation law of the area in which the services are performed. Such provisions would aid and prevent retroactive switching from the classification of employee to that of independent contractor.

In sum, we urge the subcommittee to adopt classification standards that will prevent employers from manipulating and structuring the form rather than the substance of the work relationship to meet the requirements of safe harbor provisions. Additionally, we urge that withholding on independent contractors to secure tax compliance be included in the final version of the bill.

I thank you for your indulgence.

[The prepared statement follows:]

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE, SENATE FINANCE COMMITTEE, ON INDEPENDENT CONTRACTOR TAX PROPOSALS

April 26, 1982

The AFL-CIO appreciates this opportunity to present its views on efforts to develop legislation which would assure that employers and independent contractors pay their fair share of taxes.

We urge this subcommittee to narrowly limit the use of independent contractor status so that employers will be discouraged from circumventing their responsibilities and contributing to the exploitation of workers.

Apart from the tax equity issue, the AFL-CIO is concerned that the final version of the bill could serve as a means for unscrupulous employers to manipulate the form of employees work relationships so as to benefit by having those employees classified as independent contractors.

Unless such machinations are prevented, employees will find themselves reclassified and excluded from job protections they now enjoy. For example, if reclassified as independent contractors, employees lose their eligibility for benefits under the unemployment compensation program (FUTA). These workers are also required to pay social security taxes at the higher self-employed rates; they do not have withholding for income tax purposes, and they lose opportunities for collective bargaining.

Whether a worker is classified as an employee or as an independent contractor could affect how that worker is treated under other laws. For example, many State income tax laws parallel Federal tax law and State income tax withholding generally coincides with Federal withholding rules. State unemployment compensation benefits depend upon whether workers were treated as employees and whether Federal Unemployment Tax Act (FUTA) taxes were paid on their wages.

Also, the Federal minimum wage applies to a worker classified as an employee. State minimum wage laws are similar. In addition, the reclassification of workers in firms in which some were treated previously as employees and others as independent contractors could alter the proper determination of bargaining units under labor relations laws.

Equally important, laws safeguarding work places, establishing standards for working conditions, providing workers' compensation, and affording protection from discrimination in hiring, promotion and benefits apply to workers only if they are classified as employees and not if they are classified as independent contractors. Even though a federal employment tax status reclassification is not binding for purposes of other laws, it could be a signal to administrators that the application of other laws is at issue. In sum, American workers and their families have a vital interest in the final outcome of these hearings that far transcends tax considerations.

At the same time, we applaud the stated intent of this subcommittee to secure tax compliance. The enormity of noncompliance in this area is shocking. In the last Congress, Treasury Department testimony disclosed that at least 47 percent of workers classified as independent contractors did not report any of the compensation paid to them. At that time, the annual revenue loss from such noncompliance was conservatively estimated by the Treasury at $1 billion, about two-thirds of which is income taxes and about one-third of which is payments for the social security fund.

In order to capture the lost revenue, promote tax equity, and resolve the classification problem, we urge that the existing system for withholding on employees at graduated rates be expanded to independent contractors and clear-cut classification criteria be developed. Specifically, the common law test should be replaced with one that will narrow the category of those workers who now marginally fall into the status of an independent contractor. At present, there are 20 common law factors used to determine whether an employer-employee relationship exists. This leaves the door open to inconsistent interpretation of the common law rules governing employment status.

In 1979, the AFL-CIO endorsed criteria along the lines of those suggested by the Treasury Department as a means to solve the definitional problem of independent contractor and minimize the opportunity for abuse. The suggested criteria were as follows. If a worker had:

- a substantial investment in assets (other than transportation vehicles used in a non-transportation business);
- employees of his or her own who provided a substantial portion of the services for which compensation is received;
- substantial, continuing expenses and concurrently performed services for more than one payor;
- a separate place of business (other than a home office).

If such criteria were not met, we recommended that the individual be classified as an employee for tax purposes.

We still believe that the preferred course of action to assure tax compliance and protect workers is to provide for graduated withholding for independent contractors and adopt clear-cut classification criteria such as those suggested by the Treasury three years ago.

If the subcommittee does not choose to follow that course of action, at the least we recommend that favorable consideration be given to the concept embraced in H.R. 5867. That proposal contains "safe-harbor" rules developed in the last Congress, intended to strike a delicate balance in the midst of controvery over classification standards. We feel that the criteria set forth in that bill represent less complex criteria than other pending proposals and should result in less litigation by those affected by its provisions. The proposal also provides for a flat 10 percent rate of withholding on independent contractors with some built-in exceptions. At the time of the 1979 hearings, the Treasury Department witness made the following observation regarding flat rate withholding. "Since the information necessary to implement a system for flat rate withholding on payments to independent contractors must be obtained by payors to comply with the information reporting requirements of present law (the worker's name, address and social security number), the additional costs associated with flat rate withholding should not be significant. In fact, the payor's use of the withheld tax pending payment of these amounts to the government should offset most, if not all, of these costs." While we would seek to improve H.R. 5867, we urge that this subcommittee examine its provisions as a useful starting point for deliberation.

S. 2369, introduced by Chairman Robert Dole on April 14, includes provisions for improved information reporting on payments by service-recipients to independent contractors. We recognize that it would serve to some extent to improve compliance. Unfortunately, it has been established that there is over 40 percent noncompliance by payors in the filing of informational (forms 1099) returns as compared to extremely minimal noncompliance with employers in filing the withholding form W-2. To quote past Treasury Department testimony, "information reporting can never replace withholding as a means of achieving satisfactory compliance."

Finally, we note that when S. 2369 was introduced, Chairman Dole invited comments regarding procedural issues in tax audits. In that regard, we recommend that any "safe harbor" test should by its terms be inapplicable to workers who are actually being treated by the employer as employees under the National Labor Relations Act or under the unemployment compensation law of the area in which the services are performed. Such provisions would aid in preventing retroactive switching from the classification of employee to that of independent contractor.

In sum, we urge the subcommittee to adopt classification standards that will prevent employers from manipulating and structuring the form rather than the substance of the work relationship to meet the requirements of safe harbor provisions. Additionally, we urge that withholding on independent contractors to secure tax compliance be included in the final version of the bill.

Senator **Grassley**. Dr. Schenken.

STATEMENT OF DR. JERALD R. SCHENKEN, MEMBER, AMERICAN MEDICAL ASSOCIATION COUNCIL ON LEGISLATION, OMAHA, NEBR., ON BEHALF OF THE AMERICAN MEDICAL ASSOCIATION, WASHINGTON, D.C.

Dr. **Schenken**. Thank you.

Mr. Chairman, my testimony today is made on behalf of the American Medical Association, the American College of Radiology, the American College of Emergency Physicians, and the College of American Pathologists.

In the interest of brevity, Mr. Chairman, I would ask that I be permitted to present an extremely brief summary of our position. I would presume that you would grant that request. [Laughter.]

We support the objectives and provisions as far as they go of S. 2369. Although we do support them, clarifying language is required, however, in the case of many physicians. We appreciate retention of the common law test but feel that it has been and may still be in the future open to unnecessary and costly misinterpretation. This concern was recently echoed by Senator Danforth.

Physicians have historically been properly classified as independent contractors, generally providing services to patients and not to hospitals. We recognize that noncompliance is the single most important issue involved here. And we appreciate the recent IRS study which found, as we believe, that physicians are not a problem. They had a 96-percent compliance rate.

We are asking for no special treatment or change in our present status under existing common law by and large. What we are suggesting is that several technical clarifying amendments be considered which will prevent consequences which are unintended by the committee, and undesirable for hospital associated physicians.

Mr. Chairman, that's a very brief summary, but I would be happy to answer any questions.

[The prepared statement follows:]

SUMMARY OF PRINCIPAL POINTS OF TESTIMONY OF THE AMERICAN MEDICAL ASSOCIATION TO THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE, SENATE FINANCE COMMITTEE

Presented by Jerald R. Schenken, M.D.

April 26, 1982

- Statement is made on behalf of the AMA, American College of Radiology, American College of Emergency Physicians and College of American Pathologists.

- Concern--Potential impact of pending independent contractor legislation on the tax status of hospital-associated physicians

- Physicians as independent contractors:

    - Physicians as professionals have control over their work and thus meet the common law test of control used to determine independent contractor status. Physician and not the hospital decides proper treatment for patient.

    - Historically, physicians have been regarded as independent contractors.

- IRS enforcement actions—Attempts in 1970s to arbitrarily enforce the common law rules to reclassify independent contractors, including hospital-associated physicians, as employees. Result: Congressional moratorium--due to expire July 1, 1982.

- Reason for IRS enforcement--Non-compliance. BUT physicians show very high rate of tax compliance (95.8%).

- Ninety-seventh Congress Legislative Proposals—AMA sees need for action by Congress to avoid return to unacceptable pre-moratorium situation. BUT legislative proposals fail to take into account unique circumstances of professionals. As currently written, pending legislation could permit IRS to assert that certain hospital-associated physicians are employees of their hospital rather than independent contractors.

- AMA amendments to current legislative proposals would help to remedy this problem and would provide greater assurances that physicians will not be misclassified as independent contractors.

- With addition of amendments, AMA would support pending legislation to independent contractors.

STATEMENT

of the

AMERICAN MEDICAL ASSOCIATION

to the

Subcommittee on Oversight of the Internal Revenue Service
Committee on Finance
United States Senate

Presented by

Jerald R. Schenken, M.D.

RE: Legislative Proposals Relating
to Independent Contractors

April 26, 1982

Mr. Chairman and Members of the Committee:

I am Jerald R. Schenken, M.D., a pathologist practicing in Omaha, Nebraska, and I serve as a member of the AMA's Council on Legislation. With me today is Chris Damon of the AMA's Department of Federal Legislation.

Mr. Chairman, my testimony today is made on behalf of the American Medical Association, the American College of Radiology, the American College of Emergency Physicians, and the College of American Pathologists. All of our organizations are concerned about the potential impact of pending independent contractor legislation on the status of hospital-associated physicians for federal tax purposes.

Physicians as Independent Contractors

Mr Chairman, the issue of independent contractor status for physicians goes to the very heart of professionalism. A physician has an ethical and legal obligation to assure that concern for the care of an individual patient is paramount. Hospital-associated physicians, as compared to employed physicians, should be regarded as independent contractors in that there is no attempt to exercise any control or interfere in any way with the physician's independent exercise of medical judgment on behalf of an individual patient. Agreements between physicians and hospitals may require the physician to perform certain services at the hospital, to utilize hospital equipment and ancillary personnel, but not control the exercise of medical judgment on behalf of individual patients. The physician, not the hospital, determines what procedures or treatment will be ordered for the individual patient and professional services are provided to individual patients by hospital-associated physicians in the same manner as by physicians who voluntarily serve on the hospital medical staff.

Historically, hospital-associated physicians have been considered by the Internal Revenue Service to be independent contractors under the common law rules and have not been considered employees of hospitals. This has been confirmed by Revenue Ruling and court decisions. For example, Revenue Ruling 66-274 (1966-2 Cum. Bull., 466) concerned a physician who had contracted with a hospital to serve as Director of its pathology department. The individual was paid a percentage of fees for his services and was required to pay the remuneration of any physicians he hired to assist him, and was permitted to perform services for other hospitals. The ruling held that the physician was not an employee of the hospital. The Pathology Director in question had a right to control his hours worked, was not paid a fixed salary, carried his own insurance, received no fringe benefits as the hospital's other employees, and was free to perform services for others. In its Revenue Rulings on this issue, the Internal Revenue Service has looked at the degree to which the professional had become integrated into the operating organization for which he performs services, the nature, regularity and continuity of his work for the organization, the authority of the organization to require compliance with its general policies, and the degree to which the professional has been accorded the rights and privileges established for the organization's employees generally.

Generally, the basis for determining whether an individual is an employee or an independent contractor for federal tax purposes has been the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished, the relationships of employer and employee is deemed to exist."

Given this standard, Mr. Chairman, it is our view that there is a strong presumption that practicing physicians are independent contractors absent compelling evidence to the contrary. Indeed, the court of highest review which has addressed the independent contractor question for physicians upheld this presumption (Azad vs. U.S., 388 F.2d 74 (8th Cir. 1968)).

In Azad, the U.S. Court of Appeals held that a physician-radiologist who managed the Radiology Department of a hospital was not its employee. Neither the hospital nor the doctor regarded each other as employer-employee. The physician was not controlled or supervised, did not pay rent to the hospital for its facilities, and was not subjected to hospital rules other than those which applied to all members of the medical staff. The physician was paid a percentage of fees of the Radiology Department.

Physicians generally have been considered independent contractors on the basis of their professional status and the control of their work. This is consistent with Treasury Regulation Sec. 31.3401(c)-1(c) which provides:

> "Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business or profession, in which they offer their services to the public, are not employees."

IRS Enforcement Actions and the 1978 Moratorium

In the late 1960s the IRS began to enforce, often arbitrarily, a more stringent interpretation of the common law rules on independent contractors and attempted to reclassify many independent contractors as employees. Hospital-associated physicians were included in these actions. For example, two IRS Private Rulings erroneously held that certain emergency physicians were employees of hospitals. Through a process of selective application of several of the 20 inferential common law factors, the Service reached results that completely departed from the common law control test. In one case the fact that the payor reserved the right to terminate contracts with emergency room physicians for poor performance was deemed sufficient to establish an employee relationship, notwithstanding that the physicians retained the right to refuse work assignments, were not supervised by the payor, received no employee fringe benefits, and were not provided a place of business or a guaranteed minimum income (Private Letter Ruling 7904109, October 27, 1978).

In 1979 the IRS conducted a study concerning income tax compliance by independent contractors. One of the conclusions of the IRS study was that individuals classified as independent contractors were responsible for high rates of noncompliance. However, the study also found that medical professionals showed a very favorable income tax compliance rate of 95.8%.

Because of the problems and uncertainties created by the overly aggresive IRS attempts to reclassify traditional independent contractors as employees, Congress included a provision in the Revenue Act of 1978 that imposed a temporary moratorium on IRS rulings on this issue. The IRS would have to accept a taxpayer's classification of himself as an independent contractor unless the taxpayer had no reasonable basis for independent contractor treatment. Congress has extended this moratorium several times, with the current moratorium scheduled to expire on July 1 of this year. The moratorium and its extensions have been intended to provide time for Congress to address this issue.

Legislative Proposals

In the current Congress a number of bills--including HR 4531, HR 4971, HR 5729, HR 5867, S. 8, S. 2213 and S. 2369--have been introduced to deal with the independent contractor issue. These bills provide that a person will not be considered an employee if all of the following five tests are met:

1. Control of Hours Worked: An independent contractor would have to control the aggregate number of hours actually worked and substantially all of the scheduling of hours worked.

2. Principal Place of Business: An independent contractor cannot maintain a principal place of business. If he does, the principal place of business cannot be provided by the service recipient. If the place of business is provided by the service-recipient, the independent contractor would have to pay rent for the location.

3. Investment or Income Fluctuation: An independent contractor would have to have a substantial investment in assets used in connection with the performance of the service. Alternatively, he would have to risk income fluctuation because his income is directly related to sales or to other output rather than to number of hours actually worked.

4. Written Contract and Notice of Tax Responsibilities: An independent contractor would have to maintain a written contract between himself and the service-recipient. Also, the independent contractor would have to be notified of his responsibility with respect to payment of self-employment federal income taxes.

5. Filing of Returns: Persons or organizations for whom the independent contractor performs his services would be required to file information returns.

Problems for Physicians in the Legislation--Corrective Amendments

Hospital-associated physicians see remedial legislation as being helpful in seeking a solution in that it attempts to create an objective definition of a working relationship that will be considered an independent contractor relationship. With the moratorium due to expire in July, a legislative test would act as a buffer to attempts by IRS to set its own guidelines.

The legislation has been written to fit the circumstances of non-physician independent contractors, such as salesmen, real estate agents, insurance salesmen, etc. We are concerned that it fails to take into account the unique circumstances of professionals, such as hospital-associated physicians. Our concern is that the five tests establishing the "safe harbor," as currently written, could permit IRS to assert that certain physician independent contractors are employees for tax purposes. We have developed draft language to amend the bill to help assure that qualifying physicians who traditionally have been considered independent contractors not be improperly reclassified as employees as a result of the proposed legislation. These amendments are attached to this statement. Adoption of these amendments would resolve the independent contractor issue for hospital-associated physicians, thereby relieving both the IRS and these physicians from the expense involved in continued challenges and litigation concerning this issue.

I will now discuss the problems we see with some of the safe harbor tests in the bills and also discuss our amendments addressing each problem.

Control of Hours Worked

Problem: While hospital-associated physicians generally work during shifts that the physician chooses to work, they often work longer hours than they originally chose because of the volume of patient needs and the physician's feeling of professional responsibility. Physicians are always subject to being called on to work unscheduled hours in the event of a medical emergency. The hours actually worked by a hospital-associated physician may not be completely in his control in the absolute sense implied by the legislative proposals.

Suggested amendment: Our draft amendments would modify the legislation to provide that, so long as an individual has the right to control hours worked, he would be deemed to have satisfied the test even if, in actuality, his control might be less than complete, due to professional obligations to work beyond chosen hours as a result of patient flow or emergencies. We would also ask the Committee to recognize in its report that, if an individual can periodically choose how many hours he desires to work and when he wants to work them, he will be deemed to have satisfied this test.

Principal Place of Business

Problem: This test provides that an independent contractor must not maintain a principal place of business and that if he does, the principal place of business cannot be provided by the person he provides services to unless he pays rent. It could be argued that a hospital-associated physician who performs services at a single hospital on a full-time basis (but with control of work hours and scheduling) is maintaining a principal place of business at the hospital. Our concern is that the IRS might consider the recipient of the physician's services to be the hospital rather than the physician's patients. If the IRS were to so construe the matter, physicians would be deemed to be maintaining a principal place of business provided by the hospital and would not be considered independent contractors.

Suggested amendment: Our amendment package would modify the second test relating to principal place of business to provide that a person will not be deemed to have a principal place of business if he is a licensed professional who is not required to render services exclusively for a single person or entity. For further clarification, we would ask the Committee to recognize in its report that, with regard to hospital-associated physicians, it is the patient and not the hospital that is the service recipient. Medical services are performed for the patient without regard to the location where those services are performed.

Substantial Investment of Assets/Income Fluctuation Test

Problem: This test requires that an independent contractor either have a substantial investment of assets used in connection with performance of his service or risk income fluctuations because his income is based on sales or other output rather than hours actually worked. There are two concerns here. First, the bill could be read as only relating to substantial investment of tangible assets and may not take into account a physician's substantial, but less tangible, investment of time and money in his professional education and training. Second, while most hospital-associated physicians would satisfy the income fluctuation test, since their remuneration is based on direct patient fees or a percentage of fees collected for physicians by the hospital, other physicians may work on a negotiated fee based on hours of service. Those working on negotiated fees would have difficulties meeting the second part of the test.

Suggested amendment: Our suggested amendment to this test would add language to provide that investment in assets would also include investment in education and training leading to professional expertise and formal licensing, certification or registration. We ask the Committee to recognize that for some professions, such as law, accounting and medicine, there is a substantial investment in training and education, and that this training and education should be considered an asset.

Written Contract Requirement

Problem: Many physicians practice in hospitals on the basis of appointment to the medical staff. Others practice on the basis of a handshake with the Administrator or Chairman of the Board. Still others practice on the basis of unilateral letter of understanding. Others do have bilateral contracts which meet the normal definition of that term. Requiring a written contract in all cases would unnecessarily alter present arrangements. Furthermore, since we have asked the Committee to consider the patient and not the hospital to be considered the service recipient for purposes of meeting the "place of business" test, consistent application of that concept would mean that the physician would have to have a written contract with every patient treated, and the patient would be responsible for providing the physician with a notice of the physician's tax responsibilities. This would, of course, be an unwieldly administrative requirement to impose on physicians wanting to comply with the proposed legislation.

Suggested amendment: The AMA amendment would remove the word "written" from the contract requirement so that implied and oral contracts and other informal agreements could be recognized as satisfying the test. The amendment also makes receipt of notice of tax responsibilities optional.

A Final Amendment: In addition to the above discussed amendments relating to specific tests, we also propose another amendment. As currently constructed, the legislation would require independent contractors to meet all five of the tests to be sheltered within the "safe harbor." Because of the potential ambiguities in the application of each of these tests, especially with regard to physicians, we would recommend that the bill be amended to provide that a person is an independent contractor if he meets four of the five tests. Such a change would give added assurance that physician independent contractors will not be improperly classified as employees through misapplication of technical provisions in any one of the safe harbor tests.

A copy of the amendments we have discussed today is attached to this statement. These amendments have been endorsed by the AMA, the American College of Radiology, the American College of Emergency Physicians and the College of American Pathologists.

CONCLUSION

Mr. Chairman, with the upcoming expiration of the moratorium, there is a need for Congress to act on this issue to prevent a return to the situation where the IRS sets its own guidelines. Such Congressional action would remove confusion among those who wish properly to comply with the tax laws and who want to know what they must do to continue to be characterized as independent contractors. In addition, we are concerned that further unwarranted reclassification of physicians as employees would disrupt long-standing independent contractor relationships. This result cannot be justified in the name of tax compliance, inasmuch as it has been shown that physicians pay their taxes faithfully. Because we believe the present legislative proposals do not adequately address the situation of hospital-associated physicians, we urge the Committee to modify the legislation by adopting the amendments which we have prepared. With these amendments, we support the passage of legislation to clarify independent contractor tax status. The AMA and other interested physician organizations would be pleased to work with the Committee in achieving an appropriate result in this matter.

Mr. Chairman, I would be pleased to respond to any questions that the Committee may have.

March 1982

AMENDMENTS TO INDEPENDENT CONTRACTOR LEGISLATION

The following legislative language would amend legislation (such as S 8 and HR 4531 in the 97th Congress) intending to clarify the tax status of independent contractors. The purpose of the AMA amendments is to help assure that hospital-based and hospital-associated physicians who wish to be considered independent contractors will not be improperly reclassified as employees as a result of the legislation.

There are five amendments to the independent contractor legislation. Currently, pending legislation would require that an independent contractor meet five tests spelled out in the legislation. The first AMA amendment alters this requirement to provide that an independent contractor need only meet four of the five tests to qualify.

The second amendment relates to the first "safe harbor" test relating to control of hours worked. The AMA amendment provides that, as long as the individual either controls or "has the right to control" hours worked, he or she will satisfy the test. This language recognizes that while hospital-based physicians generally work during shifts that the physician chooses to work, they often work longer hours than they originally chose due to the volume of patient needs and the physician's feeling of personal responsibility. The amendment will recognize that, as long as an individual has the right to control hours worked and can periodically choose how many hours he will work, he will have satisfied the test even if in actuality his control might be less than total due to professional obligations and unpredictable patient flow.

The third amendment relates to the second "safe harbor" test regarding place of business. In current pending legislation, an independent contractor cannot maintain a principal place of business. The AMA would exempt from this requirment licensed professionals who are not required to render services exclusively for a single person or entity.

The fourth amendment relates to the third "safe harbor" test regarding investment in assets or income fluctuation. The AMA amendment would provide that investment in assets would also include investment in education and training providing professional expertise and formal licensing, certification, or registration. This provision is included because the current pending legislation could be read as only relating to a substantial investment in tangible assets and equipment and many hospital-based physicians may not have made this kind of investment. Also, the second part of the test could not be met by some physicians who may work on a negotiated fee based on hours of service thereby precluding wide fluctuations in income.

The final amendment deals with the fourth test relating to a written contract requirement. Many physicians currently practice in hospitals without any formal written contracts. Also, it is the patient and not the hospital that is the recipient of the physician's services and a written contract with every patient would be administratively impractical. The AMA amendment would remove the word "written" from the contract requirement so that implied and oral contracts could be recognized as satisfying the test. The amendment also makes receipt of notice of tax responsibilities optional.

FIVE DRAFT AMENDMENTS TO S 8, "EMPLOYMENT TAX ACT OF 1981" AND TO HR 4531, "INDEPENDENT CONTRACTOR TAX STATUS CLARIFICATION ACT OF 1981"

(New language underlined; language to be deleted lined-out.)

(1) In proposed Section 3508, amend subsection (b) as follows:

> "(b) REQUIREMENTS. —For purposes of subsection (a), the requirements of this subsection are met with respect to service performed by any individual if four of the following five conditions are met—

(2) Amend Section 3508(b)(1) as follows:

> "(1) CONTROL OF HOURS WORKED. —The individual controls or has the right to control the aggregate number of hours actually worked and substantially all of the scheduling of the hours worked."

(3) Amend Section 3508(b)(2) as follows:

> "(2) PLACE OF BUSINESS. —The individual does not maintain a principal place of business, or, if he does so, his principal place of business is not provided by the person for whom such service is performed, or, if it is so provided, the individual pays such person rent therefor. For purposes of this paragraph, the individual shall be deemed not to have a principal place of business if he does not perform substantially all the service at a single fixed location - , or, in the case of a licensed professional, if he is not required to render services exclusively for a single person or entity."

(4) Amend Section 3508(b)(3) as follows:

> "(3) INVESTMENT OR INCOME FLUCTUATION. --
>
> "(A)
> The individual has a substantial investment in assets, or an investment in education and training providing professional expertise and formal licensing, certification or registration, used in connection with the performance of the service, or
>
> (B)
> The individual risks income fluctuation because his renumeration with respect to such service is directly related to sale or other output rather than number of hours actually worked."

(5) Amend Section 3508(b)(4) as follows:

(4) ~~WRITTEN~~ CONTRACT ~~AND~~ OR NOTICE OF TAX RESPONSIBILITIES

"(A)
The individual performs the service pursuant to a ~~written~~ contract between the individual and the person for whom such service is performed--

"(i) which was entered into before the performance of the service, and

"(ii) which provides that the individual will not be treated as an employee with respect to such service for purposes of the Federal Insurance Contributions Act, the Social Security Act, the Federal Unemployment Tax Act, and income tax withholding at source, ~~and~~ or

"(B)
The individual is provided written notice, in such contract or at the time such contract is executed, of his responsibility with respect to the payment of self-employment and Federal income taxes.

Senator GRASSLEY. I think Senator Dole said he had to go, and for me to thank you on his part for participation in his inquiry.

My first question would be to Grace Ellen. You are satisfied that the provisions of the Dole bill permit your workers to be classified as independent contractors?

Ms. RICE. Yes, we are.

Senator GRASSLEY. And do you think that your workers favor that classification?

Ms. RICE. Yes, they do.

Senator GRASSLEY. They wouldn't want any other classification? Is that basically what you think?

Ms. RICE. That's exactly right. That's according to what we have been told, and also what we know from speaking with farmers out in the country as far as the services for which they retain an independent contractor.

Senator GRASSLEY. I didn't hear your testimony, but I assume you spent a great deal of time on the insurance aspects of Farm Bureau related organizations.

Ms. RICE. That's right.

Senator GRASSLEY. What about the noninsurance aspects? Do you see any classification problems with the farm services? Am I not right? Don't some of your farm service people have independent contractor status as well?

Ms. RICE. You are referring, for instance, to custom harvesters who come in at the end of a crop year and——

Senator GRASSLEY. That would be in regard to a farmer, one of your members. No. I was thinking about Farm Bureau related affiliates other than the insurance companies that you have where they have independent contractor status.

Ms. **Rice**. To my knowledge, there is no problem with that. These people have indicated that the independent contractor status is something that is more appropriate for them than an employee status in the insurance companies and the farm service companies whether it's a safe marked program or any other kind of farm service offered to the member. They have indicated that the independent contractor status is more appropriate for them.

Senator **Grassley**. And, Mr. Koplan, you inferred this in your testimony and I wanted to pursue it just a little bit. It's about additional pressures on employees to switch to independent contractors. You obviously feel that that is one of the things that we ought to take a further look at

Mr. **Koplan**. Yes, Mr. Chairman. In fact, a comment on that. I was here and heard Mr. Chapoton's testimony. And he indicated—and this is not unlike the testimony of the Treasury in the last Congress—that the disparity in collection has put tremendous pressure on the definition of who is an independent contractor. And this is one of the reasons why we are urging this subcommitte to seriously consider withholding. I think both in the last Congress when Treasury testified, and today, I got the sense that the Treasury feels that withholding would substantially reduce these pressures in terms of who is and who is not an independent contractor.

And if I could just add a personal comment of my own. There was a time when I served in the Department of Justice in the Tax Division as a prosecutor of criminal tax cases. Based on my experience there, it is obvious that forms 1099—unlike a W-2 form—we all know, are not attached to a return. And there is a tremendous burden on the IRS for audit purposes to start cross-referencing between the 1099 and the return—Form 1040.

By requiring withholding on people, we are not creating a task. All we are saying about withholding is that it puts people them into the system. Those 5 million returns that Senator Dole mentioned earlier of people who don't file income tax returns—withholding would put those people into the system. History has shown that people who receive W-2 forms, for the most part, comply with their income tax liabilities. That is not where you find your criminal prosecutions, for the most part.

So, again, I would urge—I realize this is not in the Senator's bill. I know that he is tightening up on compliance for purposes of information reporting. But as Treasury has said both in the last Congress and in this one, the only real answer here to cut back on this problem is to deal with the withholding issue, and to provide withholding for independent contractors.

Senator **Grassley**. Is there any alternative to withholding? Because I was going to ask you in my followup questions whether there were any safeguards that you would insert in the legislation to prevent that sort of switching from happening. But I suppose if you had withholding that would take care of it. Is there any alternative to withholding that you have to suggest?

Mr. **Koplan**. I don't consider it an alternative to withholding, but in my prepared statement—I thought I had read that portion into the record—we do have suggestions on page 5 to take care of retroactive switching. And on page 5 in my prepared statement, there is a recommendation that any safe harbor test should, by its terms, be inapplicable to workers who are actually being treated by the employer as employees under the National Labor Relations Act or under the unemployment compensation law of the area in which the services are performed.

But I think the real answer to your question—these suggestions that I am making on page 5 would be of assistance, I think, to you. But the real problem that I am addressing is that if withholding applies to both employees and independent contractors on certain types of income—and I think Treasury got into that in their testimony today as well as in the last Congress—you will cut down on a lot of the incentives to classify people as independent contractors as opposed to employees. I am responding to you for purposes for tax compliance. There is a tremendous amount of revenue that is lost to the Treasury Department because, as we all know, people are not reporting their income in this area.

Senator GRASSLEY. Thank you.

And, Doctor, if you stated it in your testimony, I missed it. Do emergency room physicians enjoy independent contractor status under common law?

Dr. SCHENKEN. By and large they are considered presently to be independent contractors. Yes, sir.

Senator GRASSLEY. That being the case, then, do you feel that their tax status is going to be jeopardized if they are not within the safe harbor despite the additions to this legislation of this noninference clause?

Dr. SCHENKEN. We feel there's a significant enough risk of that to throw us back into the premoratorium days. Therefore, we are making the suggestions that we think might prevent this sort of thing.

Senator GRASSLEY. I guess I would like to have your reasoning on why emergency room physicians should be considered independent contractors when legal aid attorneys, as an example, are not. Both are professionally oriented.

Dr. SCHENKEN. I guess I would have a hard time answering that because I'm not sure about the relationship of the legal aid attorneys with their clients. Emergency room physicians—maybe I can answer that by describing emergency room physicans. They are there to provide services, generally speaking, to whoever comes in, private patients or——

Senator GRASSLEY. If that's the legitimate comparison, the Legal Aid Society attorneys, I think, would be in the same category.

Dr. SCHENKEN. But the emergency room physicians provide services to anybody.

Senator GRASSLEY. As opposed to just poor people?

Dr. SCHENKEN. Yes. Whoever walks in and has need for emergency medical care. They are available around the clock. Yes, sir.

Senator GRASSLEY. Just a minute. Let me see if I have another question.

[Pause.]

Senator GRASSLEY. In regard to emergency room physicians, are such physicians generally guaranteed a minimum remuneration like employees? Or do they risk possible loss like most independent business people?

Dr. **Schenken**. Mr. Chairman, I think there is some variability among the arrangements for considerable local reasons. And could we have the opportunity to get more definitive answers to you? And we will get them back to you.

Senator **Grassley**. Yes. In writing?

Dr. **Schenken**. In writing, yes, sir.

[The information follows:]

DISCUSSION OF ISSUE OF EMERGENCY ROOM PHYSICIANS AS INDEPENDENT CONTRACTORS

Following the prepared remarks of the American Medical Association at the April 26 hearing before the Subcommittee on Oversight of the Internal Revenue service, the Subcommittee Chairman asked the AMA witness, Jerald Schenken, M.D., several questions. Most of these questions dealt with emergency room physicians and the AMA was asked to respond to one of these questions in writing. We would like to take this opportunity to amplify our responses to all three sets of questions relating to emergency room physicians as independent contractors.

I. The first question asked whether emergency room physicians enjoy independent contractor status under common law.

As was stated at the hearing, it is our understanding that by and large they are so regarded at present. As a group, practicing emergency room physicians have traditionally considered themselves independent contractors because they view this practice as part of their general practice of medicine and receive none of the benefits normally accorded hospital employees. Independent contractor status is supported by the fact that emergency room physicians control the way in which they work; they have a professional degree; they do not receive the rights and fringe benefits of hospital employees; and they are free to contract with other hospitals and have their own private practice. Although there may be factors that are not totally consistent with independent contractor status (many emergency physicians are paid on an hourly basis, work on the hospital premises, and in some cases contract to work a set number of hours), on balance the application of relevant factors support independent contractor status. However, because we are concerned about arbitrary IRS implementation of these limited factors, we support amending the safe harbor tests to more clearly include hospital-associated physicians such as emergency room physicians.

II. The second set of questions focused on the difference between the emergency room physician and an attorney working in a legal aid office with respect to independent contractor status.

It is our understanding that a legal aid attorney works for a legal aid entity, which is usually a not-for-profit corporation providing legal assistance to a specified class of individuals (usually based on income). The legal aid attorney's position is usually full-time and he has traditionally been treated as an employee of the legal aid association. On the other hand, the emergency room physician is typically a practicing physician with his own practice who often provides emergency room coverage at one or more hospitals on a shared-time basis. The emergency room physician has been traditionally treated as an independent contractor, because of the nature of his work and because he is not integrated into hospital operations and is not provided the customary benefits normally provided hospital employees.

The application of the twenty common law factors that the Internal Revenue Service generally considers in determining whether an employer-employee relationship exists also bears out the differences between the legal aid attorney and the emergency room physician.

III. The third question asked whether emergency room physicians are generally guaranteed a minimum remuneration.

Income fluctuation is one of the tests that would be used in the proposed safe harbor legislation. Methods of reimbursement of emergency room physicians vary. Some are reimbursed on an hourly basis and may not experience substantial income fluctuation. Others are compensated on a fee-for-service basis where their income is subject to fluctuation based on the variable patient volume. Still others occupy a middle ground where they may be guaranteed minimum remuneration with fluctuation in amounts earned above that minimum. A 1977 HEW study showed that 74% of emergency physicians were compensated on a basis tied to output as opposed to a salaried basis. There is no evidence that these percentages have changed drastically since 1977.

Senator **Grassley**. All right.

I have no further questions for this panel, and this is the last panel. I want to thank this panel for your participation. I thank all the people who listened. The meeting is adjourned.

[Whereupon, at 4:45 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT
OF
MR. FRANK J. PATTERSON
PRESIDENT OF PATTERSON AND ASSOCIATES, INC.
AND CHAIRMAN, FEDERAL AFFAIRS COMMITTEE
INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.,

The Independent Insurance Agents of America, Inc., (IIAA) is the nation's oldest and largest insurance producer group. IIAA represents fifty state associations, plus the District of Columbia, and over 1,200 local boards located in major cities and counties. We now number approximately 126,000 licensed insurance agents and brokers among our membership.

We are different from either life agents or property/liability agents who produce business exclusively for one company. As independent agents we represent a number of companies and can offer our clients a choice of coverages suited to their particular needs at the most advantageous terms. We not only advise our clients regarding coverage, but also suggest ways to cut premiums or reduce losses by improvements in loss control procedures and through other risk management techniques. Equally important, we represent our clients should a loss occur. We are, in short, independent contractors who want to be certain of that status under tax law and be permitted to retain it. Most of us have incorporated businesses and average approximately eight employees per firm with some of our members having well in excess of one hundred employees.

That is why IIAA supports enactment of the Independent Contractor Tax Classification and Compliance Act of 1982, S.2369. The issue of classification of workers as either employees or independent contractors for tax purposes has had a long, and thus far, inconclusive history on Capitol Hill. IIAA vigorously opposed a Treasury Department proposal submitted by the previous Administration that would have levied a flat 10 percent withholding rate on independent contractors. The Congress rejected that proposal, and chose instead to postpone action on this important issue so that the ramifications of codifying a specific approach to the problem could be thoroughly explored, discussed and debated.

With the June 30 deadline on the current moratorium approaching, we urge you to act promptly and favorably on S.2369. Short of enactment of this bill by June 30, we would urge a continuation of the delay on IRS action. We unequivocally oppose any action that would arbitrarily classify as employees, solely for the purpose of revenue enhancement, honest taxpayers who operate independent businesses.

There has never been any doubt under the tax laws that independent insurance agents are independent contractors. The independent agent is defined by the following characteristics:

1. The independent agent sells and services the policies of several insurance companies.
2. The independent agent solicits business for his or her agency, rather than for any single company.
3. The independent agent decides the location of the agency, the types of business to be conducted, the hours of operation, who is employed, their duties, work hours, and all other decisions relating to the success or failure of the business.
4. The independent agent, not the company, owns the business accounts (expirations) that he or she has produced.

5. The independent agent is usually incorporated and files quarterly estimated taxes based upon prior year's tax liability. The corporation withholds Federal and FICA taxes from employee's salary and deposits taxes on a semi-monthly basis.

In only one technical way does the independent agent deviate from the general laws of agency. At various points in the insurance sales and service transaction the agent serves, at different times, as an agent of the insured and as an agent of the company . At no time does the independent insurance agent's relationship with his contracting companies even remotely resemble that of a salaried employee, particularly since the relationship is usually between a corporation and the contracting company. To imply or achieve such a relationship by a tax law revision would be to reject hundreds of years of common law and case law on the subject of the employment relationship between agents and principals.

It is unrealistic to assume that an independent agent subject to withholding on his or her commissions would not take on the characteristics of an employee. This subcommittee should understand that the vast majority of independent insurance agents built their businesses from the ground up, in the true entrepreneurial spirit that is the hallmark of the American free enterprise system. To turn such people into salaried employees with the stroke of a pen would be a serious social, political, and economic mistake. Further, how do you turn an incorporated, tax-paying entity into a "salaried employee"?

We will not belabor the specific points of S.2369. The subcommittee, the full Finance Committee and their respective staffs are intimately aware of the specific provisions of the bill, the history surrounding the controversy, and the current revenue situation this country is facing.

IIAA believes that the stiff penalties to businesses that don't fully report information to the IRS, together with a stringent and scrupulous application of the safe harbor tests stipulated by S.2369, will ensure widespread compliance.

Record Apr 26
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ICESA

INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, INC.
SUITE 126, 444 NORTH CAPITOL STREET, N.W., WASHINGTON, D.C. 20001, 202/628-5588

May 6, 1982

Mr. Robert E. Lighthizer
Chief Counsel
Senate Finance Committee
2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Lighthizer:

The Senate Finance Committee's Subcommittee on Oversight of the Internal Revenue Service held hearings on April 26 concerning S. 2369, a bill which would set standards for determining whether workers are independent contractors.

Our organization, the Interstate Conference of Employment Security Agencies, would appreciate the enclosed statement concerning this issue being included in the record of that hearing.

If you need other information, please let me know.

Sincerely,

William L. Heartwell, Jr.
William L. Heartwell, Jr.
Executive Vice-President

Enclosure

The Interstate Conference of Employment Security Agencies is an organization whose members administer the state unemployment compensation laws and public employment offices in the fifty states, Puerto Rico, the Virgin Islands and the District of Columbia. We welcome the opportunity to present our views concerning the establishment of legislative standards for clarifying which workers are independent contractors, and specifically the provisions of S. 2369.

From our view point as administrators of the unemployment insurance system we are concerned first, that the conditions which are set for according independent contractor status to individuals may be manipulated in a manner which would result in the shift of workers who are currently acknowledged to be employees to self-employed status. Such a shift would have serious consequences for both the economy and the lives of workers who could lose the protection of unemployment insurance benefits and other worker protections which are based on the concept of employment.

State unemployment compensation laws generally contain the same coverage provisions as the Federal Unemployment Tax Act, which is administered by the Internal Revenue Service. Whether a worker is covered by the state unemployment compensation law and the Federal Unemployment Tax Act depends on the existence of an employment relationship. A fundamental change in federal law, as proposed by this bill would, as a practical matter, have to be followed by the states. Inconsistencies between the state and federal criteria would cause confusion among employers, an increase in recordkeeping, and result in incorrect tax payments to both the states and the federal government. Due to these difficulties the states would be under tremendous pressure to follow the federal criteria.

S. 2369 contains four tests which, if satisfied, establish independent contractor status. We believe that those criteria would transform many acknowledged employees into so-called independent contractors. Slight modifications in the normal methods of computing pay and in working conditions would satisfy the first three tests. They are: (1) that the worker must control the aggregate number of hours worked and substantially all of the scheduling, (2) that the service-recipient must not provide the place of business unless the worker pays rent, and (3) the investment or income fluctuation alternative. The fourth test, a written contract, would be satisfied by describing the modified working conditions and pay provisions in contract form. Each of these criteria is discussed briefly below.

CONTROL OF HOURS

The increasing popularity of "flextime" to allow workers to set their own hours demonstrates the modern employer's willingness to allow workers to control their own hours. Many trusted employees are allowed to come and go as they please. As long as their duties are performed, the employer doesn't need to control the aggregate number of hours worked.

PLACE OF BUSINESS

A wide variety of occupations could easily satisfy the "place of business" condition. We now experience alleged rental of beautician and barber chairs, secretarial desks and typewriters, various vehicles, and space in auto body shops and repair garages, among others. In those cases the rental is rarely paid "up front" in cash. It is almost always deducted from income generated by the service performed and is controlled and accounted for by the employer. The worker receives only a net payment after the deduction. In most cases the rental is measured by income or production instead of a flat rate based on a time period as in true rental agreements. There is rarely a bona fide rental agreement with the worker having a legal right of access to the property or space "rented." It is a short step to rent space to a factory worker on a production line. That is perfectly feasible under this bill.

Of course, the rental requirement would only apply where the service must be performed at some given location or facility. It would not apply to drivers of all kinds, salespersons, pilots, construction workers, canvassers, repair people, installers, auditors, researchers or any other occupation which is not performed permanently in an office, shop or store. The added condition that the payment of fair rental is not required unless "substantially all" services are performed at a place of business provided by the service-recipient, makes that element even more vague and subject to adroit scheme.

INCOME FLUCTUATION OR SUBSTANTIAL INVESTMENT

The third condition of "income fluctuation" would be easily satisfied by changing the pay base from hours actually worked to the completion of prescribed duties which would be related to "other output" which is defined in S. 2369 as including the performance of services. The completion of prescribed duties could be anything from a bookkeeper posting to a journal, a painter painting a house, managing a motel or apartment house, or customers serviced. The list is endless and only subject to the imagination. But nowhere in the list is the profit concept considered or must there be a risk of loss.

The alternative third condition involving "substantial investment," is one with which we are experienced. Our state laws include the provisions of

Section 3121(d)(3) of the Internal Revenue Code. That section provides that certain "agent drivers" and "city salesmen" are employees if certain conditions exist. One of those conditions is that they have no substantial investment in facilities used to perform the services.

A basic problem with the "substantial investment" element is that the investment must be made by the worker, but the employer/service-recipient has the responsibility to prove it. If it is a true investment in facilities by the worker, the service-recipient, in many cases, would have no way of knowing about it. This is particularly true in situations where the issue arises from an audit after the worker is no longer associated with the company. Employers have argued that substantial investment includes such items as a desk at home, luggage, sample racks, typewriters, adding machines, craftman's tools or numerous other assets.

We are pleased to see that this bill provides that vehicles for transportation are not to be considered a substantial investment. Most workers today use a vehicle for transportation. Without this exclusion, a vehicle would invariably be considered a "substantial investment," and that criterion satisfied.

WRITTEN CONTRACT

In our experience the bargaining position of an employer when dealing with a prospective worker is so overwhelming that the worker will usually sign the contract which is offered. In practice, the unemployed worker usually has little choice but to accede to the conditions of a prospective job whether he agrees or not. In short, this element is merely clerical in nature and does not determine the relationship between the worker and proprietor.

GENERAL COMMENTS

Historically, the concept of an independent contractor equates to being in business for oneself. Ideally, an independent contractor holds himself out generally or to a significant part of the business community in an identifiable way as being in business and ready to provide a particular kind of service to customers or clients. The bill does not require any demonstration of an independent business venture, yet that is the one factor of the common law test which is easiest to demonstrate and most difficult to manipulate.

The broad effect which the language of this bill would produce is evident when considering the construction industry. Usually, construction work is not performed at a fixed location, but moves from one job site to another. Building contractors compute and bid jobs on a unit cost basis. Extending that concept to base workers' pay on portions of the whole job would be simple and logical. Then, setting rigid deadlines for completion of assigned units, rather than prescribing hours of work, would complete the requirements of this bill and free the employer from the responsibility of payroll taxes. Narrow profit margins and competitive bidding would soon force adoption of a new, industry-wide work pattern. Employers could still exercise close supervision over the work performance because direction and control would no longer determine the worker's status.

TAX COMPLIANCE

In previous hearings, the Internal Revenue Service stressed the disappointing level of compliance with our tax laws among persons classified as independent contractors compared to employees subject to the withholding system. We support the elements of this legislation which seek to improve the level of compliance among independent contractors. However, we are concerned about the loss of revenue to the financially troubled federal unemployment trust fund, including the individual state trust fund accounts.

An important additional consideration is tax support for the social security system. Even if every redesignated former employee fully complied (which probably will not happen), revenue from this expanded class would be reduced by 25 percent while benefit obligations remain the same.

SUMMARY AND RECOMMENDATION

We recognize the need for greater predictability in the determination of independent contractor status. However, we believe that the tests which this bill would establish could have much broader implications than are intended. As an alternative to this approach, we urge you to consider adopting narrowly drawn exclusions specifically restricted to named occupations. Such an approach would have a high degree of certainty of application and would assure that only those occupational groups which Congress intends to address are affected. Limiting the exclusions to clearly defined occupations would also allow you to consider accurate estimates of the consequential effect on federal revenues in your deliberations.

In summary, the states and territories are aware that a problem exists and are vitally interested in its resolution. We believe the problem will best be resolved through regulated standards of application for the common law of employment, with statutory exemptions for particular industries or occupations. We are sincerely convinced that the approach of S. 2369 will compound rather than resolve the problem. The result will be manipulation and unfair competition with grave effects upon communities, workers, and the general public. The Interstate Conference of Employment Security Agencies urges you to reject this proposal, retain the common law concept of direction and control as the hallmark of the employment relationship, and to grant specific occupational exclusions only where you are convinced that a need exists.

Record

NRA/NHIC

National Remodelers Association/
National Home Improvement Council, Inc.

STATEMENT OF

JOHN HAMMON, EXECUTIVE VICE PRESIDENT,

NATIONAL REMODELERS ASSOCIATION/

NATIONAL HOME IMPROVEMENT COUNCIL

SUBMITTED TO

SENATE FINANCE SUBCOMMITTEE ON OVERSIGHT

OF THE INTERNAL REVENUE SERVICE

HOLDING HEARINGS

ON

S. 2369,

INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982

Headquarters • 11 East 44th Street, New York, N.Y. 10017 • 212/867-0121

The National Remodelers Association/National Home Improvement Council (NRA/NHIC) is the recently merged trade association which represents the residential and light commercial remodeling industry. We are appreciative of this opportunity to present our views in support of the Independent Contractor Tax Clarification and Compliance Act of 1982, S. 2369, introduced by Senators Dole, Danforth, Boren, Roth, Durenberger, Symms, Wallop, Johnston, Kassebaum, and Laxalt. We urge that the Committee favorably report this bill. This legislation would accomplish the following:

- Provide reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or an independent contractor.
- Provide a "safe harbor" by giving certainty as to tax status to independent contractors who are able to satisfy the five strict requirements outlined in the bill. However, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five "safe harbor" provisions. This "safe harbor" approach is important because it would be virtually impossible to design one specific legislative proposal to clearly meet the needs of all the numerous occupations and industries affected by the issue.
- Offer a measure of certainty to those industries, such as the remodeling industry, where the IRS's attempt to reclassify individuals as employees has disrupted business relationships.

Various industry studies show widely differing figures for the number and type of remodeling contractors in the country. The likelihood is that the number is in excess of 100,000 contractors who are generalists in the remodeling, room addition and general home improvement business or who are roofing/siding specialists, kitchen/bath remodelers or insulation contractors. Industry studies show that the average remodeler employs 8 or 9 full-time employees and 2 or 3 part-time. By virtually every applicable federal definition of "small business," the remodeler is included in that definition.

The largest single grouping of remodeling contractors throughout the country is the small entrepreneural family unit that specializes in skilled craftsmanship in a general remodeling, home improvement business with no more than two or three employees. These family units employ people with similar skills and backgrounds. The typical contractor has little if any accounting or business background. He depends essentially on 20 or more separate types of craft specialists or independent subcontractors: the electrical contractor, the sheet metal specialist, the roofer, the brick mason, et cetera. These skilled craftsmen, in their turn, are fiercely independent. They prize their entrepreneural status and do not wish to be designated as "employee." The general contractor cannot exist without these special skills.

Section 530 of the Revenue Act of 1978 was much appreciated by the small business community in America. It recognized that the definition of "employee" in the tax statutes left something to be desired, and afforded an opportunity for IRS harrassment. This industry was especially hard hit. Many received claims of the Federal Government for so-called back taxes, penalties and interest of amounts in the 6 and 7 figures -- totals that would in almost every instance wipe out our business if the government seriously attempted to collect. And in almost every instance the claim was based on our utilization of independent contractors and the attempt by the government to characterize these entrepreneurs as our "employees."

In hearings before a House subcommittee in July of 1979, we testified in support of the Gephardt Bill, H.R. 3245, and heartily endorsed the "safe harbor" test that offered the opportunity for the small businessman to have some degree of assurance that by meeting the five-point test, he would be free of IRS harassment. At the same time, we welcomed the reaffirmation by Congress of the traditional common-law test for those who have been historically treated as independent contractors.

Our support for the safe-harbor approach of S. 2369 is based upon our position that remodeling contractors must be able to operate with a degree of certainty that their independent contractor/principal relationship will not come under repeated scrutiny by the Internal Revenue Service. The five-point test provides that certainty.

Our support for the Dole bill goes beyond the five points of the independent contractor test, however. The proposed legislation also provides new measures to improve compliance among independent contractors and their payors without imposing an across-the-board automatic and mandatory withholding from payments made to them. The previous Administration proposed such a move, and it was immediately opposed by independent contractor groups such as NRA/NHIC and other member associations of the Small Business Legislative Council. It was our view then, as it is now, that the large majority of remodeling contractors are in compliance with payroll tax requirements through the provisions of the existing 1099 system. The additional recordkeeping requirements imposed on small remodeling contractors would have the effect of placing those contractors in the position of monitoring compliance and collecting taxes for the Internal Revenue Service.

NRA/NHIC remains unalterably opposed to mandatory withholding provisions, and we're happy to note that except in those cases where an independent contractor refuses to voluntarily supply information to the service recipient, that S.2369 has abandoned this coercive approach to payroll tax compliance. We reiterate our continuing support for passage of a statutory definition of independent contractors, and our strong support for efforts to ensure compliance through use of the reporting mechanisms now in place. The 1099 system was established to provide the IRS with the information it needs to monitor tax payments. If that system is somehow deficient, then remedies to correct it must be enacted. But Congress must first ensure that the tax reporting systems currently in place are reliable before seeking to impose additional taxes on those who are already in compliance with the law.

We support S.2369 and its safe-harbor independent contractor test, and we urge this body to adopt this bill's approach and end the uncertainty over this issue which has lingered since 1978.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE TO THE IRS OVERSIGHT SUBCOMMITTEE OF THE SENATE FINANCE COMMITTEE ON S. 2369, THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982

May 6, 1982

The purpose of this statement is to present the views of the American Council of Life Insurance on The Independent Contractor Tax Classification and Compliance Act of 1982. We appreciate this opportunity to present the Council's views on the issue of classifying workers, particularly life insurance salesmen, as either employees or independent contractors for employment tax purposes.

The American Council of Life Insurance is the major trade association of the life insurance business with a membership of 524 life insurance companies which, in the aggregate, have approximately 96% of the life insurance in force in the United States and hold 97% of the assets of all United States life insurance companies.

SUMMARY

We support S. 2369 which would amend the Internal Revenue Code to provide certain tests for determining the status of individuals for employment tax purposes. We believe that adoption of statutory objective standards which, if satisfied by an individual, will enable the individual to be treated as an independent contractor for employment tax purposes, will provide the certainty and uniformity that is essential to the effective operation of the employment tax laws.

Background

Currently, Code §3121(d)(2), with certain specific exceptions, defines an employee as "any individual who under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." Basically, the common law is a set of factors based on court decisions and custom which is used to classify an individual as an employee or independent contractor.

The focus of the common law in this area revolves around the employer's right to control the way an employee works, both as to the final result and as to when and how that result is accomplished. (The IRS has adopted twenty factors to be considered in determining employment status.) In making this determination, no single factor is conclusive. Moreover, the degree of importance of each factor varies in each case.

Application of the common law rules to complex and changing business arrangements is very difficult and has produced inconsistent results. At best, a decision to go one way or the other as respects a particular relationship involves a significant degree of uncertainty as to how the IRS will react. These problems are particularly pertinent when attempting to classify a life insurance agent because of the myriad of arrangements between agents and their companies that are used to market life insurance.

Despite the inherent weaknesses with the common law standard for determining whether an individual is an employee or independent contractor, the impression was created for many years that the common law definition of "employee" was a workable standard, since the IRS, until recently, raised few challenges regarding the employment tax status of individuals, including life insurance agents. During the past few years, however, (prior to the Congressional ban on IRS employment tax audits) the IRS had increasingly challenged the previously unquestioned employment tax status of workers in many industries and occupations, including the life insurance business. The experience of our member companies indicates that these employment tax audits appeared to involve a change of position by the IRS and, in some cases, a rejection by the IRS of prior private letter rulings issued to companies holding agents to be independent contractors. This increased audit activity and challenges substantially eliminated the predictability that t one time seemed to exist and made it clear that the common law definition is clearly too imprecise to be the primary test to be used in determining the employment tax status of individuals.

In order to provide an interim solution to the controversies that had developed in employment tax audits while Congress attempted to enact a substantive solution to the problems, the Revenue Act of 1978 contained a provision (section 530) which prohibited the IRS from reclassifying an individual as an employee for employment tax purposes for any period ending before January 1, 1980, if a business had a reasonable basis for treating such individual as an independent contractor. This ban was subsequently extended to June 30, 1982. In view of the approaching deadline, Congress must act quickly to enact substantive legislation setting forth appropriate and clear tests to be used in classifying individuals as employees or independent contractors.

S. 2369 Provides an Appropriate Solution

S. 2369, introduced by Senator Dole, is designed to provide a permanent solution to the problem of classifying workers for employment tax purposes. The bill sets forth five requirements which, if satisfied, would result in a worker being treated as an independent contractor. If one or more of the five tests is not met, the individual's status will be determined under the common law rules.

To fall within the safe harbor test set forth in the bill, an individual generally: (1) Must control the number and scheduling of hours worked; (2) Must not have a principal place of business or, if he has one, it cannot be provided by the person for whom the service is performed unless reasonable rent is paid therefor; (3) Either must have a substantial investment in the assets used in connection with the services performed or must risk significant income fluctuation; and (4) Must perform the services pursuant to a written contract that spells out his status as an independent contractor and the tax obligations associated with that status. In addition, the person for whom the service is performed must meet certain reporting requirements set forth in the bill.

We believe S. 2369 provides an appropriate approach for clarifying the employment tax status of individuals, including life insurance agents. The requirements set forth in the bill are, in our view, an appropriate dividing line. The tests can be easily applied and will provide the certainty and uniformity that is so necessary if our tax laws are to work efficiently and effectively.

It has been argued that this type of approach would permit workers, including life insurance agents, to be treated as independent contractors. This implies, of course, that without a bill of this type, life insurance agents would be treated as employees. It ignores the very real controversy that has developed over recent years and which lead to the stopgap legislation passed by Congress and Congressional efforts to come up with a rational and administrable set of guidelines.

The possibility of "manipulating" an employer-employee relationship to meet the requirements of this type of legislation has also been cited as a reason for opposing bills of this type. There is a strong implication that such "manipulation" would be for tax-avoidance purposes. For whatever reason, if an employer and an employee rearrange their working relationship so as to meet the independent contractor criteria, that change should be recognized--it is more than mere manipulation. The real issue is whether the criteria are correct, and we believe they are.

Strengthening Information Reporting Requirements

S. 2369 also contains recommendations with which we agree, for strengthening the information reporting system. We believe payees should be given a copy of any information return filed with the IRS so that there is no doubt about the amount of compensation to be reported by them. Moreover, to assist the IRS in its enforcement function, we suggest that the information return be required to be attached to the individual's tax return, as is currently the case with Form W-2.

In addition, we do not object to the proposal to increase the penalties for failure to file an information return or an accurate return with the IRS and to apply this penalty to the failure to furnish such return to the payee.

We appreciate having the opportunity to present the Council's views on the issue of classifying workers for employment tax purposes. We would be happy to attempt to answer any questions the Subcommittee may have.

Recd Apr 26

STATEMENT OF SIGMUND ZILBER, ON BEHALF OF THE INTERNATIONAL TAXICAB ASSOCIATION BEFORE THE SENATE FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE CONCERNING THE CLASSIFICATION OF WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS FOR PURPOSES OF FEDERAL EMPLOYMENT TAXES

May 10, 1982

The International Taxicab Association (ITA) is pleased to have this opportunity to present its view of S. 2369, a bill which seeks to establish the "Independent Contractor Tax Classification and Compliance Act of 1982."

ITA is the sole trade association in the taxicab industry, representing taxicab operators in every state and all major cities in the United States. The members of ITA own or control over half of the principal corporations which operate taxicabs in the United States.

S. 2369 proposes to set up standards whereby certain workers would avoid classification as employees for purposes of Federal employment taxes. With some modifications, ITA is in favor of the standards set forth in the bill.

The members of ITA have considerable familiarity with the problem this proposed legislation seeks to address. It is a well-established practice in the industry for taxicab companies to lease their taxicabs to drivers for a fee. In accordance with a written lease agreement, the rental fee to the driver is comprised of a fixed amount plus a mileage charge. The drivers are free to transport passengers and to retain the fares collected, without being required to account to the companies in any manner. The drivers do not report to the companies as to their operation of the taxicabs, and the company does not supervise or review their activities. The drivers set their own hours and may terminate their services at any time.

Historically, the use of a lease system, in which the taxicab driver is an independent contractor, has been a common practice for many small taxicab operators, especially in the South, since the 1930's. In recent years, however, even major operators in large cities have adopted a lease system for part or all of their operations because of its advantages. A substantial proportion of the taxicabs on the streets of such major cities as Miami, Chicago, Houston, and Los Angeles are now being driven by independent contractors. Taxicab operators have adopted the lease system primarily to effect a significant reduction in administrative costs, thereby partially counterbalancing the steady rise in general operating costs and permitting the continued provision of taxicab services without excessive fare increases.

As the law presently stands, the drivers under these standard leasing arrangements are not viewed as employees for purposes of Federal employment taxes. The driver's income is, however, taken into account for purposes of the tax on self-employment income.

The Internal Revenue Service has taken the position that, under the facts as I have described them, there is no common law relationship of employer and employee between the taxicab companies and their drivers. As a result, the IRS has concluded in Revenue Ruling 71-572 and many private rulings issued over the years that these leasing arrangements do not make the drivers employees under the relevant employment tax provisions.

This legal position has proven beneficial to taxicab companies and drivers alike. It has provided flexibility and efficiency in taxicab operations, and has permitted the leasing practice to flourish, with resultant economic benefits to companies, drivers, and the taxi-riding public.

Experience has shown that the lease system permits drivers to increase their earnings substantially through skill and hard work. The great popularity of the lease system among drivers results from the fact that it makes each driver an independent businessperson, who is responsible for the expenses of conducting his business and is entitled to retain all of the earnings he receives in serving the members of the public. The lease system, in which the driver is an independent contractor, is therefore truly an embodiment of the essence of the free enterprise system.

The leasing practice has reduced administrative costs to the companies and has provided substantial incentives to the drivers. The practice has also resulted in lower fares than would be the case under non-lease arrangements. These benefits would not be available were the companies required to treat the drivers as employees for tax purposes.

S. 2369 contains provisions which retain the common law rules that have developed. The bill seeks to provide, in addition, a clear statutory standard which, if met, would place certain workers outside the scope of the Federal employment taxes. The addition of such a standard to the body of the law adds a needed element of certainty and permits parties to structure their business relationships in a manner which will avoid the employer-employee classification.

S. 2369 is beneficial to the taxicab industry in that it does nothing to alter the existing law, as set forth in the IRS rulings. Moreover, it provides a clear guideline in the event the taxicab industry should ever seek to make alterations to its leasing arrangements or in the event the IRS should review its position and revise its rulings.

S. 2369 lists certain standards which must be met if a worker is to avoid classification as an employee. These standards appear in subsection (b) of a new section, 3508, of the Internal Revenue Code. In general, taxicab drivers operating under our leasing arrangements will have no difficulty in meeting the requirements of that subsection.

Specifically, ITA has these comments with respect to the requirements of proposed section 3508(b), appearing in S. 2369.

One of those requirements consists of a two-part test, stated in the alternative, involving the investment the worker has in the equipment he uses and involving the risk of fluctuations in the worker's income. As to the need for a worker to have a "substantial investment" in the assets, we believe some clarifying language would be helpful. Currently pending on the House side is a somewhat similar bill, H.R. 4531, which provides that the "substantial investment" test will be satisfied where the worker rents the asset and is entitled to a rental deduction. We believe it would be useful to incorporate such a provision in section 3508(b), as it appears in S. 2369.

Another of the section 3508(b) requirements set forth in S. 2369 relates to a situation where a "service-recipient" provides a principal place of business to a worker. Here again, we believe some clarifying language would be helpful. Several pending House bills (e.g., H.R. 4531, H.R. 4971, and H.R. 5729) do not treat the providing of a place of business to a worker as a critical factor when the worker does not perform his services at a "fixed location". We believe that the addition of a similar "fixed location" exception to S. 2369 would eliminate some uncertainty as to the application of this requirement, insofar as it relates to taxicab drivers.

In addition, it is the view of ITA that S. 2369 would be improved if new section 3508 contained some of the language found in H.R. 4971. The version of section 3508 appearing in H.R. 4971 contains two alternatives to the subsection (b) requirements. Under H.R. 4971, a worker will also avoid classification as an employee if he meets the tests of subsection (c) or subsection (d). We support the inclusion of these additional tests in new section 3508.

We would suggest two changes, however, to the subsection (c) requirements, as set forth in H.R. 4971, relating to the worker's investment in and maintenance of the assets he uses to perform the services. Here, too, we believe it should be made clear that the "substantial investment" test can be satisfied when the worker leases the assets.

As to the H.R. 4971 requirement, in new section 3508(c), that a worker must be repsonsible for the maintenance of the assets, we would prefer that clarifying language be added to make this provision compatible with the current practice under the taxicab industry leasing arrangements. Those leases contain a provision requiring the driver/lessee to return the vehicle in the condition in which he received it. Of necessity, such a provision imposes a duty on part of the driver to provide some degree of operational maintenance, although no one would suggest that this duty extends to extensive repairs of the vehicles. We do not believe there should be a requirement in the statute for a lessee of equipment to provide other than such minor operational maintenance. The responsibility for major repairs and overhauls is a heavy duty to place on a worker, and it is a matter which really has no direct bearing on the question of whether or not he is an employee. We submit that the duty to maintain leased assets is a subject best left to the agreement of the parties. It should not be made a matter of critical importance for the purposes of this legislation. It may be useful, in view of the potential for widely varying interpretations as to the scope of the term "maintenance", to give some thought to deleting this requirement altogether.

In addition, we would suggest a minor modification to subsection (d), as it appears in H.R. 4971. That subsection permits a worker to avoid employee status when he has performed similar services for five or more payors during the year. The meaning of the word "payor" is not clear here and, to be consistent with the rest of the statute, should be changed to "service recipient". Since taxicab companies do not make payments to drivers under the standard leasing arrangements, it is possible that subsection (d) could be viewed as inapplicable to taxicab drivers. We therefore believe that some clarification is warranted to avoid the unnecessary exclusion of this group of workers.

It is also the opinion of ITA that the legislation, as finally approved, should contain the provision, currently in H.R. 4531, relating to Tax Court appeals. Under this provision, an adverse IRS determination as to a worker's status as an employee for purposes of Federal employment taxes may be appealed to the United States Tax Court, without the need to pay the tax first. We view such access to the Tax Court as essential in view of the developing controversies in this area of law.

The International Taxicab Association is hopeful that Congress will enact employee-classification legislation which contains the best features of S. 2369 and includes the modifications we have suggested. We respectfully urge speedy and favorable consideration of such legislation.

COMMENTS
# of the
AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION

Before the

COMMITTEE ON FINANCE

on

S. 2369
"The INDEPENDENT CONTRACTOR TAX CLASSIFICATION
AND COMPLIANCE ACT OF 1982"

U.S. SENATE

May 10, 1982

The American Newspaper Publishers Association is pleased to submit its views on S 2369, designed to clarify the tax status of independent contractors.

ANPA is a non-profit trade association whose more than 1400 newspapers represent more than 90 percent of the daily and Sunday newspaper circulation in the United States. Several nondaily newspapers also are members. ANPA is joined in this statement by the National Newspaper Association and the International Circulation Managers' Association. NNA represents some 500 smaller city daily and 5,000 weekly newspapers throughout the United States and its territories. ICMA is an association of some 1350 newspaper circulation executives, mostly in the U.S.

Historically, newspapers as principals have engaged the services of independent contractors for performance of both editorial and commercial functions. There is no study known to ANPA which would pinpoint the number of independent contractors providing services to newspapers, but it is a matter of general knowledge in the newspaper business that publishers have traditionally used significant numbers of contractors for important tasks such as distribution to readers and newsgathering in remote or sparsely populated areas. Independent circulation distributors undoubtedly number in the thousands. 1/ Freelance correspondents are still a universal feature at both daily and nondaily publications. Other newspaper contractors include regional and rural delivery agents and independent advertising solicitors. These newspaper workers are proud of their status as independent businessmen and seek to maintain the benefits enjoyed by individual entrepreneurs under the American free enterprise system.

ANPA member publishers are vitally concerned that existing tax treatment of traditional contract arrangements be left undisturbed. As in the case of other employers, a newspaper may be secondarily liable for taxes owed by individuals whom the Internal Revenue Service administratively determines to be employees. This may occur in spite of management's good faith belief that the individual concerned is being dealt with on the basis of a contract arrangement and even in spite of express agreements over tax responsibility.

ANPA also believes that provisions of the Internal Revenue Code describing the line of demarcation between employees and independent contractors should contain adequate safeguards against arbitrary findings of employment relationships by federal tax authorities. Where potential past liabilities arising from adverse determinations of coverage may total thousands of dollars, fundamental fairness

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1/ With respect to independent newspaper distributors, our comments relate to persons who are age eighteen and older, and those who are not engaged in sale and delivery of the newspapers to the reader under a wholesale-retail arrangement. The services of minor carriers delivering to the reader, as well as the services of individuals selling and delivering to readers under a wholesale-retail arrangement is already removed from the operation of the federal tax laws by virtue of specific provisions in the Internal Revenue Code, regardless of the legal relationship between newspaper and distributor: 26 USC 3401 (a) (10) (A&B) -- Withholding; 26 USC 3306 (c) (15) (A&B) -- FUTA; 26 USC 3121 (b) (14) (A&B) -- FICA.

requires that a taxpaying principal have meaningful guidelines that will enable him to ascertain whether a contract for personal services will give rise to a duty to withhold wages for the contractor's future tax obligations.

ANPA believes that in its overall concept S 2369 would be an important and commendable addition to existing tax laws, and would help preserve existing tax treatment of traditional newspaper independent contractor arrangements. However, several specific provisions of the bill would be onerous for both newspapers and their contractors and should be amended before being submitted for Congressional consideration.

The "Safe Harbor" Test

The four part "safe-harbor" test contained in proposed section 3508 subsection (b) of the Internal Revenue Code of 1954 combines the essential elements of common law tests for independent contractor status and would permit an orderly evaluation of the tax-law status of particular arrangements made with individual workers.

Except as noted below, compliance with the various parts of the test would likely not place an unconscionable burden on taxpaying principals, although ANPA believes that traditional newspaper independent contractor arrangements are well within the purview of either the common law or the proposed statutory analysis, or both.

The first element of the test focuses on control of working hours by the independent contractor rather than the principal -- reflecting the general view that an independent businessman arranges his or her own schedule for meeting the demands of the contract. That is the situation with newspaper contractors in traditional arrangements. For example, a newspaper distributor in usual circumstances carries out all the work of distribution and related activities such as billing and newscarrier training completely free from time constraints by the publisher, save for a general mandate that the newspaper be delivered the reader as soon as possible after publication.

The second part of the test in proposed section 3508 requires that if an independent contractor has a principal place of business that it be furnished by the contractor and not the employee. In the newspaper business, contractors work from their homes and rarely have occasion to visit the newspaper plant for any length of time.

The third element of the "safe harbor" test -- alternative requirement of investment in substantial assets or income fluctuation -- is unsatisfactory in a number of respects, at least as currently drafted.

Concerning income fluctuation, the bill provides that a contractor must risk income fluctuation due to 90 per cent of remuneration being directly related to sales or other output. While all newspaper contractors' income is directly related to output, the bill poses the possibility that the Internal Revenue Service may require the contractor or the service recipient to demonstrate that he or she actually faced the risk of loss of income as well as the possibility of making a profit.

In some instances this might be impossible for a newspaper independent contractor to demonstrate. For example, an independent newspaper distributor might be servicing a newly developed neighborhood, and would face only the prospect of an increasing number of subscribers and consequent increases in income. Thus while the distributor's income is related to output in the sense that increased work will result in greater numbers of subscribers, the newspaper or distributor might not be able to demonstrate that he or she risked loss of income.

The apparent, and understandable, intent of this provision in S 2369 is to deny "safe-harbor" status to persons who are merely "salaried" by the service recipient. But it seems to be aimed at workers who are, for example, selling consumer merchandise in the home, and does not adequately provide for "safe-harbor" status for other legitimate independent contractor arrangements.

The provision in the subsection relating to investment in assets is also deficient when viewed from the newspaper perspective. It states that the investment in assets must be, "a substantial economic investment in light of the nature and amount of the remuneration received for the service ..." This wording is somewhat vague, but the clear suggestion is that a contractor's tangible assets expense must be a significant percentage of income.

This does not reflect the economic realities of some newspaper independent contractor arrangements. For example, in the case of a freelance writer, what is being contracted for is the individual's journalistic skills and time spent in coverage of a story. A freelancer is unlikely to have any appreciable investment in assets beyond a typewriter, library or photographic equipment. A newspaper distributor has an investment in delivery supplies, but it cannot be known whether the investment would be "substantial" within the meaning of S 2369, since the term is nowhere defined. Again, it would appear that the legislation in this respect might deny "safe-harbor" treatment to perfectly legitimate contractual arrangements involving newspapers.

The assets test also purports to exclude as a qualified asset, "any vehicle which is used primarily to transport the individual (and any tools, samples or similar items)..." In his remarks accompanying the introduction of S 2369, Senator Dole stated clearly that, "A vehicle used primarily for performing services, however, is not excluded under this rule." Nevertheless, this appears to be at variance with the express wording of the proposed statute.

It would be important for newspapers to obtain clarification of this aspect of the "safe-harbor" rule, since a vehicle may be the principal -- and perhaps most important -- asset of some newspaper independent contractors. Many freelance journalists are heavily dependent on their automobiles for transportation to and from news events that are to be covered and to deliver stories and photos to the newspaper. The same would apply to independent advertising solicitors who must visit potential clients over a widespread geographic area. To deny "safe-harbor" status to these contractual arrangements because of the use made of a necessary vehicle does not comport with the intent of the legislation to insulate such arrangements from unwarranted attack by the Internal Revenue Service.

The fourth requirement of the "safe-harbor" section is for a written contract and corresponding notification of tax responsibilities. The specific provision resembles the form of contract and notice used in the newspaper business, and probably other businesses, for longer term contractual relations. But, it seems insufficiently flexible to deal with contractual arrangements of short duration entered into on a one-time or very sporadic basis. The purpose of the fourth requirement is, of course, to insure that a worker is alerted to the fact that he or she is not an employee, and will have to assume responsibility for tax matters.

This purpose, we believe could be served in the circumstances described by permitting the contract and notice requirement to be satisfied by an executed oral agreement with notice evidenced by a writing. To illustrate, a newspaper might on occasion engage the services of a freelance journalist in a distant city to cover a single news event. The freelance will generally be told that payment is on a fee basis, and it is agreed that he or she must be responsible for payment of federal and state taxes. When subsequent payment is made to the contractor, usually after completion of coverage, there will generally be no indication of withholding for any purpose, and payment will generally be accompanied by notice of tax responsibility. This sort of arrangement should not be denied "safe-harbor" status due to absence of a prior written agreement. The goal of notifying the worker of non-employee status and tax responsibility will have been met as a practical matter, and for very occasional services there is no danger that large tax liabilities will accrue. S 2369 can and should be amended to allow "safe-harbor" treatment for sporadic contractual relationships, perhaps with a limitation on the number of times that any procedure could be used within a particular tax year.

Reporting and Penalty Provisions

As a substitute for previous Internal Revenue Service proposals that service recipients withhold a percentage of payments to a contractor, proposed Section 6041A imposes enhanced reporting duties for such payments. It may be argued that reporting requirements are preferable to withholding, but this proposed Section nevertheless constitutes additional government paperwork duties and regulation.

The majority of newspapers are small businesses, and it is well known that small business in general is already laboring under an intolerable burden of government-imposed recordkeeping and paperwork. Therefore, ANPA vigorously opposes any addition to present requirements. This is especially true in light of the fact that existing Code Section 6041 already provides a framework for reporting payments to a contractor.

S 2369 contains proposed Internal Revenue Code Section 6660 which specifies penalties for failure to file the returns called for in proposed Code Section 6041A. Although it is acknowledged that the Internal Revenue Service should have some mechanism for insuring reporting of payments to contractors, for compliance purposes, ANPA must note its opposition to the punitive approach embodied in the proposed Section.

On its face S 2369 is very complex and technical tax legislation which will undoubtedly generate rulemaking on the part of the Internal Revenue Service. If passed, the law will require thorough analysis by attorneys, accountants and others who must advise their business clients using contractors about the scope of their duties, if any.

As with other small businesses, there may be a prolonged delay before some newspapers become aware of the new law, much less be able to get a determination concerning its effect on any existing contractor arrangements. Some may not become aware of the new law at all, and,as with any novel legislation of this type, there will certainly be initial uncertainties about the extent of its application.

There should be no penalties at all imposed on a first time failure to file a required return. It is unconscionable to levy heavy monetary sanctions against small businesses in connection with a new tax law. Moreover, the purpose of compliance provisions of the type contained in S 2369 should be to insure compliance -- not to punish businesses for failure to fulfill requirements whose exact parameters may be unclear. The bill should be amended accordingly or the penalty provisions deleted.

In conclusion, ANPA supports the concept of continued protection for traditional contractor arrangements embodied in S 2369. Congress acted wisely in affording temporary "safe-harbor" status to independent contractor arrangements in the interim relief provisions of the Revenue Act of 1978, effectively prohibiting reclassification efforts by the Internal Revenue Service. We are in general agreement with the concept of S 2369 because this legislation perpetuates that wisdom. The bill is in keeping with the spirit of American free enterprise, and it contains guidance by which all parties -- the Internal Revenue Service, service recipients and workers -- can be confident about their tax responsibilities.

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[illegible] Apr 26

STATEMENT OF THE AMERICAN HORSE COUNCIL

ON S. 2369

Subcommittee on Oversight of the Internal Revenue Service

SENATE COMMITTEE ON FINANCE

Mr. Chairman. The American Horse Council appreciates this opportunity to submit testimony on the Independent Contractor Tax Classification and Compliance Act of 1982 (S. 2369). This bill would define and clarify the status of independent contractors for the purpose of federal income, employment and social security tax withholding.

The bill would establish statutory "safe harbor" tests which guarantee independent contractor status, if the five requirements are met. If not met, the common law rules would be retained for determining the employment tax status of workers. The bill will also strengthen the information reporting requirements on employers and increase penalties.

The American Horse Council is a national association, consisting of over 140 equine organizations that represent over three million individual horsemen and women. A significant number of the people working in the horse industry have been treated as independent contractors because of the nature of their activities and the business. The AHC and its members are very concerned over recent IRS actions to reclassify independent contractors as employees.

Under common law, a worker is considered an employee rather than an independent contractor when the person for whom the services are performed has the right to control and direct the individual not only as to the result to be accomplished, but also as to the details and the means by which it is to be accomplished. There are approximately twenty factors to be considered in determining whether sufficient control exists to find that a worker is an employee. Reasonable men can differ on the outcome of the tests and Senator Dole's bill attempts to bring some certainty to the area.

The bill would establish a five-part safe harbor test. If all of the tests are met, an individual would be treated as an independent contractor under the bill. These requirements relate to: 1) control of hours worked; 2) place of business; 3) investment or income fluctuation; 4) written contract and notice of tax responsibilities; and 5) the filing of required returns.

The first requirement -- control of hours worked -- would be met if the worker controls both the aggregate number of hours worked and most of the scheduling. The bill takes into consideration, and disregards, any limitations on scheduling that result from government regulatory requirements, operating procedures and specifications placed upon the person for whom services are performed, coordination of the service with the performance of other services, or the control of access to the premises by the service-recipient so long as the individual controls the scheduling of hours once access is granted.

The second requirement -- place of business -- would be met if the worker has no principal place of business provided by the service-recipient.

The third requirement -- investment or income fluctuation -- could be met two ways. First, the investment or income fluctuation test would be met if the worker has a substantial investment in tangible assets which he uses in connection with the service. Alternatively, this requirement could be met if the worker risks income fluctuations because more than 90 percent of his income is directly related to sales or output rather than number of hours worked.

The fourth requirement -- written notice -- would be met if the individual performed services pursuant to a written contract which expressly provides that he is not treated as an employee and gives him notice of his tax responsibilities.

Finally, the service recipient must file all the required information returns regarding payments made to the worker.

The horse industry is a substantial industry. In the last twenty years there has been tremendous expansion in horse sports, particularly in racing, showing and rodeos. Twenty-thousand horse shows a year provide entertainment for more than five million fans. The racing industry in 1981 handled over $12 billion in wagers in 29 states and generated a source of income for 175,000 people. It also provided another 125,000 jobs in subsidiary industries, such as breeding farms, feed suppliers, manufacturers and service industries.

Workers in the various segments of the horse industry are difficult to characterize. The nature of racing and showing is such that many of the key people involved in putting on the activity do not work year-round for a single employer. Many horse shows run only a few days and then participants move to another location for the next show. Similarly, many race tracks operate only a few months during the year and the the admissions crews, mutuel managers, racing officials, jockeys, etc. move to another track. In most cases, these people are responsible for their own activities, even though there are some practical constraints on their operation.

Horse show personnel may work at thirty or more shows in a year and racing officials may serve at four or five different tracks each year. Despite the itinerant nature of their work, however, these people are highly skilled. They are generally treated as independent contractors and various employers bid for their services. In many cases, they move in whole crews, set up, and operate the venture involved. Any decision by the IRS to reclassify these people as employees rather than independent contractors would create serious problems for the industry and disrupt their traditional ways of operating. The American Horse Council opposes any effort by the IRS to change long-standing industry standards.

Senator Dole's bill would create in the law a "safe harbor" test. There will be no question that those who meet all five tests will be independent contractors and that income, unemployment, and social security taxes would not have to be withheld from amounts paid to them for their work. This brings a degree of certainty to the law which is now lacking.

At the same time, Senator Dole's bill provides that a service provider who does not meet one or more of the tests would not automatically be considered an employee. Rather, the determination of the status of these workers would be made by common law rules, as if the safe harbor tests had not been enacted. Thus, while providing the specificity necessary to add certainty to the law, the bill also retains a degree of flexibility which ensures that an equitable decision can be reached in many cases by considering the specific facts and circumstances of a worker's particular situation.

While supporting the intent of the bill, we believe further safeguards may be needed for those working in industries such as ours where unusual conditions prevail. It is not clear whether the occupations discussed earlier would fall within the "safe harbor" created by S. 2369. Yet the fact that these are occupations in which a skilled person works in a variety of locations during a given year for different clients is an unusual situation. It should also be noted that these occupations are seasonal in nature, and that the independent contractor has considerable control over which offers he will accept and the periods when he will work, and also has the opportunity to independently negotiate his compensation and working conditions.

State Law

The bill provides that qualification as an independent contractor under the safe harbor tests would not create any infererence with respect to a person's status under provisions of law other than the federal employment tax provisions. A number of states have statutes that classify workers at race tracks -- jockeys, for example -- as either independent contractors or employees for purposes of state laws. The AHC feels that this federal statute, which deals with federal employment tax provisions, should not affect state statutes. Each state should continue to be able to classify workers operating within its boundaries according to what it considers to be the public purpose. If this is the bill's intent this relationship to state law should be clarified.

We repeat our support for a workable, legislative solution to this problem. We urge the Subcommittee to note and resolve the special problems faced by those who work in the industries of an unusual nature, such as the horse industry.

Rem Apr 26

Statement of
The Associated General Contractors of America
Presented to the
Subcommittee on Oversight of the
Internal Revenue Service
Committee on Finance
United States Senate
May 10, 1982
on the Topic of
Independent Contractor Tax Proposals

AGC is:

- More than 30,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
- 113 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
- Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) represents more than 30,000 firms, including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. We appreciate this opportunity to submit written testimony regarding the standards used for determining when individuals are not employees for purposes of employment taxes and other related purposes.

AGC has testified on the issue of the tax classification of independent contractors in prior years. We are pleased to be able to support the approach to resolving this issue contained in S2369. We believe S2369 and other proposals pending before Congress are sincere efforts to improve tax compliance while maintaining the independent contractor status for income tax purpose.

The construction industry in the United States is characterized by thousands of small businesses. The entrepreneurs involved in construction are independent people willing to assume the risks of business in exchange for the benefits of success. The relative ease of entering the construction industry is critical element of maintaining a competitive industry which performs construction services for the nation at the lowest possible cost. Maintaining the tax status of independent contractors, with the appropriate income reporting responsibilities, is a significant factor in preserving the competition within the industry.

AGC's basic policy regarding a solution to the independent contractor issue is the statutory recognition of a safe harbor which includes equipment owner/operators, the most significant group of independent contractors in the construction industry and a general statutory recognition of the common law principles which have been used historically to classify independent contractors. There are numerous business functions in construction. Drafting a single safe harbor to provide certain classification for all such independent contractors would be extremely difficult if not impossible. The common law principles should be recognized by statute to eliminate the potential for reclassification of independent contractors to employees. While a safe harbor will provide protection for those individuals covered, only the common law can provide a sound basis for administering the continuation of this class of small business people. AGC has been on record supporting increased tax compliance of all business people as a responsibility of citizenship. However, penalties must be structured to increase compliance and not be disguised as revenue collection devices themselves.

SAFE HARBOR RULES

The safe harbor provisions in the bills currently pending in Congress generally provide a five part test where each element must be met. The difficulty of drafting such a multi-part test can be seen in its application to the major categories of independent contractors as discussed below. The recognition of traditional common law principles as an alternative to the safe harbor is a necessity for preserving this class of individuals.

Control of Hours Worked

The first of the five part tests generally deals with the issue of controlling the work function. The test is based on the control of hours worked. S2369 would provide a general solution to the independent contractor situations which are common in construction. However there are instances when the safe harbor would not be applicable based on the identical work function and organization. As a result it is necessary to recognize the common law principles by statute.

In construction, it is often necessary for a general contractor to schedule a variety of activities which must be performed at the same time. For example, dump trucks must be available at the time backhoes and cranes dig out soil. S2369 allows equipment operators to have their control limited due to operating procedures and specifications the service recipient is required to comply with by contract. While this rule would exempt equipment scheduling in most construction project situations it would not apply to a project being performed by a general contractor who is also acting as a developer. In this situation there would be no contract to perform the work and despite activities identical to that performed if a contract existed, the operators would not be eligible for safe harbor protection. This example again illustrates the difficulty of drafting a single rule and the necessity of a statutory recognition of the common law principles.

Place of Business

The second part of the five part test requires that a place of business for performance of the service not be provided by the service recipient unless paid for by the independent contractor. We suggest that it be made clear that access to the job site and temporary parking or equipment storage facilities made available at the site not be construed as providing a place of business. It is a necessity that work be performed at a job site in construction and often it would be prohibitively expensive for equipment owner-operators to move their equipment each night.

Investment or Income Fluctuation

The third safe harbor test requires that the independent contractor be subject to the risks of income fluctuations. The test is applied in two alternative parts. The first part requires that investments in assets are significant in value and that the investment in the assets be substantial when compared to the remuneration. The value of vehicles used to transport the individual and/or his tools is generally excluded. The alternative test recognizes the potential of income fluctuation if more than 90 percent of the remuneration results from remuneration based on output rather than hours worked.

We believe an income fluctuation test is appropriate as a safe harbor requirement. However, we question the wisdom of excluding the value of vehicles used to transport individuals and/or tools to a job site. In construction, there are a variety of independent contractor functions. The skill in using certain tools makes them valuable even if the tools themselves are not "significant" in relation to remuneration. The exclusion of vehicle value from the investment test may bar certain individuals, especially those starting in business, from the safe harbor protection even though they have a significant personal investment in their business activity. We believe a substantial asset test would be a legitimate test without excluding the value of vehicles.

The alternative income fluctuation test is based on the form of compensation. To qualify for safe harbor protection 90 percent of the remuneration for service must be based on output. Industry billing practices are based on hourly compensation rates often, even for identifiable projects (e.g. installation of wiring or plumbing). The billing arrangement based on hourly rates is used due to an inability to estimate costs due to unforeseeable complications in the construction process. The procedure can also lower costs if a general contractor is well organized. As a result some functions will not be eligible for safe harbor inclusion. This is another example of why the common law principles must be recognized even though the safe harbor rules generally cover the most significant category of independent contractors in construction - equipment owner/operators.

Written Contract

AGC recognizes the beneficial aspects of requiring a written contract as a compliance mechanism as the fourth part of the safe harbor test. However, in construction independent contractors often deal directly with job site managers. Adding to the paper work of these individuals is not an insignificant cost. The difficulty in gathering information accurately from job sites should not be underestimated. These practical difficulties of record keeping will undoubtedly lead to the failure of some firms to comply with the safe harbor by foregoing the written contract requirement even if the independent contractors would qualify under the substantive portions of the safe harbor rule. This is another example of the necessity of providing statutory recognition of the common law as an alternative to the safe harbor protection.

FILING PENALTIES

AGC recognizes information filings as a tax compliance device. While increased penalty coverage will undoubtedly improve tax compliance, the imposition of those penalties must be tempered by the recognition of the burdens of paper work under which businesses operate today. They should also be based on factual information as to the inadequacies of current penalties to increase tax compliance. Informational filing penalties were increased significantly in August of last year as part of the Economic Recovery Tax Act of 1981. We are aware that the increased penalties enacted last year have been subject to a vigorous analysis by the IRS which shows their inadequacy.

COMMON LAW RECOGNITION

Recognition of the traditional common law principles is the most significant factor in preventing arbitrary reclassification attempts by the IRS. While a statutory safe harbor protecting equipment owner/operators is an essential element to a resolution of the independent contractor issue, the common law is needed due to the difficulty of drafting a safe harbor covering the variety of functions traditionally performed by independent contractors in construction.

S2369 contains a "no inference" clause stating that the failure to meet the requirements of the safe harbor classification of independent contractors shall have no implication on the classification of the individual under the common law tests. The no inference clause as structured does not preserve the common law principles from future regulatory changes. We suggest, as we did in our testimony before the Subcommittee on Slect Revenue Measures of the Ways and Means Committee on July 17, 1979, that the no inference clause include the current IRS definition of independent contractors to preclude later attrition of the classification by IRS expansion of the present common law test enlarging the employee definition and narrowing the independent contractor definition.

Record

MAY 11 RECD

NICOR DRILLING

One of the NICOR basic energy companies

500 Reunion Center, 9 East Fourth Street, Tulsa, Oklahoma 74103-4068, Phone 918 587-5507

May 10, 1982

BY HAND

Robert E. Lighthizer
Chief Counsel
Committee on Finance
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Re: S. 2369

Dear Sir:

We support S. 2369 because it would clarify the status of independent contractors under the Internal Revenue Code. Please include this statement in the record of the April 26th hearing of the Subcommittee on Oversight of the Internal Revenue Service.

In the course of fabricating oil rigs, NICOR Drilling Company contracts with drilling rig welders on an "as needed" basis. The welders are required to provide and maintain their own welding equipment and supplies. We pay them an hourly rate which covers both their labor and a return on their equipment. Many welders are incorporated; some own more than one rig and hire their own assistants; many work with more than one fabricator in any given year. As is the custom in the industry, we have always treated drilling rig welders as independent contractors.

As explained by Senator Dole, drilling rig welders would, in most cases, satisfy the tests in S. 2369. Even though we must manage the times and locations when and at which the welding is done in order to integrate their welding with our other work, the welders control the aggregate time they work, and they have substantial investments in their equipment.

We understood that the Treasury has suggested that who controls the hours worked may not be relevant to whether withholding is appropriate. We agree and would support dropping that condition.

Sincerely,

Wendell D Cleaver

Wendell D. Cleaver
President

An Investor-Owned Taxpaying Business

26 in [illegible]

Statement of

Sutherland, Asbill & Brennan
Washington, D.C.

on behalf of

THE NATIONAL ASSOCIATION OF LIFE COMPANIES

for inclusion in the record of the
April 26, 1982, Hearing

of the
Subcommittee on Oversight of the Internal Revenue Service
of the Senate Committee on Finance

on
Legislative Proposals Relating to Independent
Contractors

May 10, 1982

This statement is submitted on behalf of the National Association of Life Companies (NALC), an association of nearly 300 life insurance companies. The NALC, whose principal office is in Atlanta, was organized in 1955. Its members are active in 40 states, Canada, and Puerto Rico, represent more than 60 million policyholders, and have more than 400,000 shareholders and 170,000 employees.

I.

The Subcommittee on Oversight of the Internal Revenue Service is to be commended for holding its April 26, 1982, hearing on S. 2369 and other legislative proposals relating to independent contractors. The independent contractor issue -- the question of what standards should be used in classifying individuals as independent contractors rather than employees -- is without question a vexing one. It is an issue that Congress has long wrestled with, and one whose resolution, unfortunately, has been repeatedly deferred. As Senators Dole and Grassley and Assistant Treasury Secretary Chapoton agreed during the April 26 hearing, the delay must end. Permanent legislation should be promptly enacted to afford taxpayers the certainty and predictability they unquestionably need to plan and conduct their business affairs.

To this end, the NALC strongly urges the Subcommittee to act favorably on S. 2369, the independent contractor bill introduced by Senator Dole and cosponsored by several members of the Committee on Finance, including Subcommittee Chairman Grassley. We heartily endorse the concept of an independent contractor safe harbor and agree that the standards set forth in S. 2369 represent a reasonable and balanced approach to the problem: they will preserve the traditional and historical status of certain individuals -- including commission life insurance agents -- as independent contractors, without opening the door to wholesale abuses or threatening to increase the level of tax noncompliance.

The NALC also supports in concept the compliance provisions of S. 2369. We have long believed that the high level of tax compliance among insurance agents is attributable to the industry's adherence to the information reporting requirements of the Code. Accordingly, the NALC applauds the decision last year as part of the Economic Recovery Tax Act of 1981 to require payors to provide their independent contractors with copies of Forms 1099 (something most insurance companies have long done). By enacting additional compliance provisions similar to those contained in S. 2369, Congress will be serving notice that non-compliance among independent contractors will not be tolerated. */

The NALC suggests, moreover, that compliance could be further enhanced by requiring independent contractors to attach copies of their Forms 1099 to their income tax returns. Such a requirement (which is, of course, already present in respect of Forms W-2) would not only make IRS "matching" easier, but as Senator Dole observed during the hearing, it would also make it more likely that independent contractors would in the first instance report and pay tax on the full amount of their compensation. We further suggest, however, that concern with compliance should not detract from what has been and properly remains the principal subject at hand: resolution of the status question.

II.

There is no need to belabor the past, to recount the administrative and judicial precedent treating commission insurance agents as independent contractors. It is sufficient to

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*/ In this regard, however, the NALC shares the concern voiced by witnesses at the hearing (including Assistant Treasury Secretary Chapoton and Mr. Daniel Stanton of the General Accounting Office) that the bill's penalty surcharge provisions may prove unduly complex and difficult to administer.

note that, under the twenty-factor common law control test, commission insurance agents have traditionally and consistently been treated as independent contractors, and that treatment has been accepted by the IRS and sanctioned by the courts. */

That treatment must now be statutorily affirmed. We urge Congress to act to preserve the independent contractor status of commission insurance agents and other groups of workers who historically have been accorded that status. The safe harbor standards of S. 2369 will do that, and consequently, we urge prompt enactment of the bill.

S. 2369 represents a vast improvement over the common law control test. Two of the bill's five safe harbor tests -- the "written-contract-and-notice-of-tax-responsibilities" test and the "filing-of-required-returns" test -- will be comparatively easy to apply: either the tests will be satisfied or they will not. Moreover, by requiring that the individual's contract be written and that it specify his tax responsibilities

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**/ See G.C.M. 18705, 1937-2 C.B. 379; S.S.T. 249, 1938-1 C.B. 393; Rev. Rul. 54-309, 1954-2 C.B. 261; Rev. Rul. 54-312, 1954-2 C.B. 327; Rev. Rul. 59-103, 1959-1 C.B. 259; Rev. Rul. 69-287, 1969-1 C.B. 257; Rev. Rul. 69-288, 1969-1 C.B. 258; Reserve National Insurance Co. v. United States, 74-1 U.S. Tax Cas. (CCH) ¶ 9486 (W.D. Okla. 1974); Standard Life & Accident Insurance Co. v. United States, 75-1 U.S. Tax Cas. (CCH) ¶ 9352 (W.D. Okla. 1975); Kelbern M. Simpson, 64 T.C. 974 (1975). The independent contractor status of life insurance agents under the common law test was recently affirmed in a case involving an NALC member company. See Investors Heritage Life Insurance Co. v. United States, 79-1 U.S. Tax Cas. (CCH) ¶ 9394 (E.D. Ky. 1979), accepting and adopting magistrate's report and recommendations, 79-1 U.S. Tax Cas. (CCH) ¶ 9246 (E.D. Ky. 1979).

as an independent contractor, those provisions by themselves should enhance compliance with the tax laws.

The bill's other three tests -- the "control-of-hours," the "place-of-business," and the "investment-or-income-fluctuation" tests -- focus on the essence of worker control and economic independence: whether the individual controls the time when he works, the location where he works, and how long and how hard he works. Stated differently, safe harbor protection under S. 2369 turns on whether the amount of money a worker earns is determined not by the mere number of hours worked, but by what is produced or how much is invested in the effort. By limiting the inquiry to five tests, the bill will enable not only taxpayers but the IRS as well to easily and fairly determine whether or not a particular individual is an independent contractor.

III.

Given the historical treatment of commission insurance agents as independent contractors and the well-reasoned balance struck by S. 2369, the NALC is confident that most commission life insurance agents will easily qualify for safe harbor protection under the bill. With regard to S. 2369's specific tests and the Treasury Department's response to them, the NALC offers the following comments.

"Control-of-Hours" Test

Unlike Assistant Secretary Chapoton, who testified that an individual's ability to control the number of hours he works and the scheduling of those hours is "seldom relevant" to a determination of his status as an independent contractor, the NALC believes inclusion of the "control-of-hours" test in S. 2369 is quite appropriate. Under the common law test, which focuses on the presence or absence of a "control" relationship between the service-recipient and the worker, the worker's freedom to set his own hours and scheduling can be critical in distinguishing an independent contractor from an employee. S. 2369 properly recognizes this fact by including a "control-of-hours" test.

The NALC is concerned, however, that a statement by Senator Dole when he introduced S. 2369 might be misconstrued to restrict certain cooperative efforts by agents. (Senator Dole's introductory comments appear in the Congressional Record at 128 Cong. Rec. S3506-10 (daily ed. April 14, 1982).) With regard to the "control-of-hours" test, Senator Dole stated that "a salesman who is required * * * to attend customers during particular office hours specified by the service-recipient, will not meet the control of hours test * * *." It should be made clear that the service-recipient's requesting an agent to handle inquiries at an agency office for a few hours a week will not cause the agent to fall outside the safe harbor, for in such a situation the agent will without question continue to control the scheduling of substantially all the hours worked. In other words, the service-recipient's imposition of certain truly *de minimis* scheduling requirements should not cause an individual to fail the "control-of-hours" test.

"Place-of-Business" Test

At the April 26 hearing, Assistant Treasury Secretary Chapoton argued that safe harbor treatment should be predicated on the individual's maintaining a place of business separate from that of the service-recipient. It is unclear from Mr. Chapoton's statement whether the Administration would require an individual who does not perform the bulk of his services at a single fixed location to have a separate place of business. Commission insurance agents, of course, fall within this category, performing their services for the most part on the road, traveling from home to home, prospective policyholder to prospective policyholder. S. 2369 recognizes that many independent contractors perform their services under similar conditions by providing that these individuals will be deemed not to have a principal place of business. The NALC urges the retention of this portion of S. 2369's "place-of-business" test.

"Investment-or-Income-Fluctuation" Test

Both Assistant Treasury Secretary Chapoton and Mr. Stanton of the GAO recommended that the income-fluctuation prong of this test should be modified to require that the individual bear some risk of loss. Their comments, however, reflect a lack of appreciation about the "risks" an independent contractor takes. The risk of not earning any money at all is a very real risk: an individual who runs that risk -- whose level of compensation turns exclusively on his own efforts -- is economically independent, and the safe harbor bill should recognize this independence. Consequently, if an individual's remuneration is wholly sales-based, the fact that he incurs only a relatively limited amount of business expenses should not preclude his qualifying under S. 2369's safe harbor provisions. */

Stated simply, the individual who runs the risk of earning no income at all (because he makes no sales or because the small commissions he earns are offset by his modest business expenses) should not be treated any differently from the individual who incurs significant business expenses in his work. That the income-fluctuation test was included in S. 2369 as an alternative to the bill's investment test reflects a clear recognition and appreciation of this point. Any proposed modification of the alternative income-fluctuation test should be rejected.

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*/ Similarly, the service-recipient's provision of certain government-mandated materials (e.g., state insurance department approved policy applications) should not, by itself, place an individual beyond the safe harbor.

Application of S. 2369 to Statutory Employees

As drafted, S. 2369 will have no effect on the status of individuals who, notwithstanding their common law status as independent contractors, are treated as employees for Social Security (FICA) purposes under section 3121(d)(3) of the Code. These individuals, including "full-time life insurance salesmen," are currently treated as independent contractors for income tax withholding purposes but as employees for FICA purposes, and they are often referred to as "statutory employees."

At the April 26 hearing, the recommendation was made by Mr. John McNeer on behalf of companies utilizing the services of "traveling or city salesmen" -- another category of statutory employees under section 3121(d)(3) -- that these salesmen should not be denied the opportunity to rely on the safe harbor tests of S. 2369 for income tax withholding purposes. The NALC endorses that recommendation. Quite simply, there is no logical reason to exclude otherwise qualifying workers from S. 2369's safe harbor simply because their status for FICA purposes is not determined under the common law. If adopted, this recommendation would not upset or in any other way affect the status of these individuals for FICA purposes. Rather, it would simply allow them, like all other individuals whose status for income tax withholding purposes is currently determined under the common law control test, to avoid the uncertainty and unpredictability of that test by satisfying the bill's safe harbor provisions. We urge you to adopt this proposal. */

IV.

Congress should promptly enact S. 2369. The bill will not only protect the status of traditional independent contractors, but will provide taxpayers, as well as the IRS, with the certainty and predictability that only permanent legislation can provide. Should enactment of such permanent legislation before June 30 prove impossible, however, the NALC recommends that the interim relief afforded by section 530 of the Revenue Act of 1978 be continued.

Respectfully submitted,

SUTHERLAND, ASBILL & BRENNAN

By Jerome B. Libin
Jerome B. Libin

Timothy J. McCormally
Timothy J. McCormally

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*/ If this recommendation is adopted, certain conforming changes will have be made in other provisions of S. 2369 (e.g., the written-contract provision).

Statement of

THE RETAIL FLOORCOVERING INSTITUTE

on

S. 2369

"THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982"

Submitted to

THE SUBCOMMITTE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

SENATE COMMITTEE ON FINANCE

May 10, 1982

The Retail Floorcovering Institute (RFI) is a national trade association headquartered in Chicago, Illinois, representing more than 4,500 retail carpet outlets. RFI member companies account for approximately 54 percent of all floorcovering products sold at retail in the United States.

Our association strongly endorses S. 2369, introduced by Senator Robert Dole of Kansas, as a balanced bill which will effectively resolve the long-standing tax controversy involving independent contractors. If S. 2369 is enacted, we believe the taxpayers will have the proper guideposts and the kind of certainty about their tax obligations that have been sorely missed in the past.

We very much appreciate this opportunity to submit this statement to the Subcommittee, and we hope that our views on this issue assist the members of the Subcommittee in resolving the controversy surrounding the tax status of independent contractors. Since the Internal Revenue Service instituted its campaign to challenge the status of independent contractors, our industry's use of installers has been the target of countless IRS audits which have resulted in costly and lengthy battles and untold aggravation for floorcovering retailers. While we certainly appreciate the moratorium prohibiting IRS reclassification audits that Congress approved in 1978, and later extended, we are hopeful that you will approve S. 2369, which, in our opinion, will equitably resolve the issues in the independent contractor tax controversy.

HOW IS THE INDEPENDENT CONTRACTOR USED IN THE RETAIL FLOORCOVERING INDUSTRY?

The Retail Floorcovering Institute in a poll of its membership found that 70 percent of our members use independent contractors for installation work.

To explain how the floorcovering industry utilizes independent contractors, an RFI member, owner of a five-store chain operating in the Midwest, provides the following narrative:

> The independent contractors that we engage do carpet and tile installation of products purchased from our showrooms. We use both independent contractors and our own employees for this work. I have often been asked why we could choose an independent contractor/installer over an employee/installer. My answer is that we simply have fewer problems with our independent contractors. They are much more conscientious about their work, and it is a totally different relationship than we have with our employees.
>
> The independent contractors that we deal with come to our firm looking for work. Obviously, we make an effort to determine whether an individual can perform to our standards, and we will generally check some of his past work. Once we are satisfied that he can do his job, we will give him the opportunity to bid for the job.
>
> After we decide to enter a business relationship with his firm, we use a contract which clearly specifies that the independent contractor is not an 'employee' of our company and that he is fully responsible for payment of all applicable federal, state, or local taxes.
>
> The independent contractors will normally request as many workdays each week as they wish. We will try to provide them with jobs to install on the days they have requested. A good many will want to work every day. Some may then hire additional employees of their own, or split up and form two different installation companies. Some are very new at this business, and they want all the work they can get and don't care

to seek out other business. But, it is very important to understand that just because an installer wants to do 100 percent of his business with my firm (and, frankly, we do have independent contractors who work predominantly for us), that does not make him any less an independent businessman than someone who might want to work 10 percent for me and 10 percent for nine other firms.

I would further emphasize to the Subcommittee members that it is very important for them to understand that when customers have made a purchase, we try to accommodate their schedules and set the time for installation accordingly. For example, if the purchase is made on a Saturday, the customer might request the installation work on the following Tuesday. We do everything in our power to oblige the customer's schedule. It is important to note that the customer, in most cases, establishes the time for installation, and not the retailer. I would hope that it is clear that our scheduling of the installer's individual jobs is done to accommodate the customer and is not a factor indicating control over the independent contractor/installer.

S. 2369, "THE INDEPENDENT CONTRACTOR TAX CLARIFICATION AND COMPLIANCE ACT OF 1982"

We believe that the "Safe Harbor Test" contained in S. 2369, introduced by Senator Dole, will be the primary basis upon which members of this industry will attempt to qualify installers as independent contractors. Given the problems that industry members have had with inconsistent IRS audits, we seriously doubt that many floorcovering retailers will resort to the 20 requirements in the "common law test" employed by the IRS.

We would like to discuss the elements of the "Safe Harbor Test" in S. 2369 and examine the impact that they may have on industry members who will seek to qualify installers as independent contractors:

Section 2.(b) (1) Control of Hours Worked.

The individual installer does control the aggregate number of hours that he works and, substantially, all of the scheduling of the hours worked. Of course, it is the customer who ultimately determines the scheduling, and to the extent that an accommodation is made, the legislative history should be clear that such scheduling of the hours worked by the individual who provides a service would not fall outside the requirement of Section 2.(b) (1).

Section 2.(b) (2) Place of Business.

Our industry would have no difficulty complying with this section.

Section 2.(b) (3) Investment or Income Fluctuation.

In the floorcovering industry, installers will have an investment in tools and supplies necessary to perform their trade. We trust that this type of investment would be considered "substantial." Clearly, an individual installer risks income fluctuation, and his remuneration will be based on the number of jobs that he is willing to undertake, as well as the size of installations.

Section 2.(b) (4) Written Contract and Notice of Tax Responsibility.

Our industry association believes that a written contract between our member firms and installers would be appropriate, and we have no hesitancy to spell out in that contract the fact that the individual installer will not be treated as an employee for the purposes of the Federal

Insurance Contribution Act, the Social Security Act, the Federal Unemployment Tax Act, and federal and state income tax withholding. Further, we agree that the individual should be reminded in this contract of his obligation to pay self-employment and federal income taxes.

Section 2.(b) (5) Filing of Required Returns.

We believe it is proper that our members be obligated to file 1099 (NEC) returns, and we commend Senator Dole for proposing that informational reporting requirements be subject to a more stringent penalty for failure to comply than is presently the case. Because we, as an industry, are very much concerned with the allegations of noncompliance, we believe it is incumbent upon the Internal Revenue Service to match properly the 1099 (NEC) returns of the businesses with the income tax returns and social security tax payments of individual taxpayers who perform services as independent contractors. Accordingly, RFI also endorses the Dole-Grassley Taxpayer Compliance Improvement Act of 1982 (S. 2198).

RFI RECOMMENDATIONS

The Retail Floorcovering Institute believes that the Dole independent contractor bill, together with the Taxpayer Compliance Act, would accomplish the objective of assuring that the tax dollars owed to the federal government by independent contractors will be paid. The Congress is contending with the difficult task of narrowing projected budget deficits, and the members of RFI have no sympathy for those citizens who contribute to the budgetary dilemma by not paying their "fair share" of taxes.

Resolution of the controversy surrounding the tax status of independent contractors has been unnecessarily burdened for years by special interests seeking to expand the definition of an independent contractor to suit their particular needs. The Retail Floorcovering Institute believes that S. 2369, if enacted, equitably shares the responsibility of reporting compensation paid to independent contractors and assuring that taxes due are, in fact, paid.

We urge the Subcommittee and full Committee on Finance to report S. 2369 without delay.

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INTERNATIONAL FRANCHISE ASSOCIATION

STATEMENT OF
THE INTERNATIONAL FRANCHISE ASSOCIATION
ON THE
"INDEPENDENT CONTRACTOR TAX
CLASSIFICATION AND COMPLIANCE
ACT OF 1982"
S.2369
SUBMITTED TO
THE SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Monday, May 10, 1982

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The International Franchise Association (IFA) is an organization representing more than three hundred franchising companies in the United States and around the world. The IFA is recognized as the spokesman for franchisors in all legal and legislative matters affecting franchising.

Independent Contractor Status in Franchising

One of the cornerstones of franchising is the independence of a franchisee who can own and operate his own business while drawing upon the training, experience, and market expertise of the franchisor. The typical modern franchise can be accurately characterized as a contractual arrangement between two independent businesses in which the franchisee is licensed to use the trademark, trade name, and business system of the franchisor. In many cases, the franchisee is incorporated and frequently is the owner of several franchised units. Usually the franchise is granted for an initial franchise fee coupled with ongoing royalty payments. Royalties paid for the use of the trademark and the business system are typically stated as a percentage of the gross sales of the franchised business. In return for these fees, the franchisor typically provides a variety of services which may include market assistance, training, advertising, accounting services, quality control advice and other business consultation.

Franchising spans a surprising range of businesses in our economy; it is utilized as a method of distribution in as many as forty different industries. Statistics published by the Department of Commerce indicate that one out of every three retail dollars is spent through a franchised businessperson.

The independent status of the franchisee is vital to this fast growing innovation in American business. The independent franchisee is in every sense a modern entrepreneur; and it is this independence which motivates franchise owners and thus lends to the success of franchising as a method of distribution.

Senate Bill S.2369

The International Franchise Association supports the efforts of Senator Dole to clarify this important area of the law and initially supported those efforts when legislation was introduced in the Congress by Senator Dole and Congressman Gephardt in 1979. We believe that the franchisor-franchisee relationship clearly is and should remain one of independence. Only on rare occasions has the Internal Revenue Service challenged the independent status of the franchisee, but such challenges have occurred. The Internal Revenue Service has set forth its views of the common law test of independence in enumerating twenty factors to be evaluated in making such a determination.

Whenever these tests have been applied to franchise relationships, the conclusion has been reached that the franchisee is indeed an independent businessperson and not an employee of the franchisor. However, on occasion field representatives of IRS have given a strained interpretation to certain of these factors to support an argument that because of the controls exercised by a franchisor over certain activities of the independent members of his franchise system, a franchisee should be treated as an employee for tax purposes. To prevent recurring attempts of this nature by the IRS, the International Franchise Association supports S.2369, the "Independent Contractor Tax Classification and Compliance Act of 1982."

We do, however, note certain aspects of the Bill as now proposed which require clarification. The franchise relationship should meet the safe harbor tests set forth in Section 2 of the Bill. However, the application of the safe harbor analysis to the franchise relationship is not altogether clear as presently proposed in the Bill.

Under the terms used in S.2369, independent contractor status analysis often leads to an anomalous conclusion. For instance, the "payment" in the context of the franchise relationship is most evident in the form of franchise fees, advertising fees, and other fees paid by the franchisee to the franchisor in exchange for business services provided by the franchisor. It is not clear, under these circumstances, who would be the "service-recipient."

It is generally understood that an independent franchisee is an "independent contractor," operating his or her business pursuant to a written agreement with the franchisor. It follows that the franchisor should be a "service-recipient" under the Bill. The definition in the Bill of a service-recipient is as follows:

Service-recipient. -- For purposes of this section, the terms "service-recipient" means the person for whom the service is performed.

From the proposed definition, the inference is drawn that the "service-recipient" pays for the services performed, but franchisors do not "pay" in the normal sense for "services performed" by the franchisee. Franchisors are contractually bound in most instances to provide certain services to the franchisee. For those services and for the use of the trademark, it is the franchisee who makes payments to the franchisor. In these circumstances, it is readily apparent that the franchisor is not the agent or employee of the franchisee and we know of no instance where that has been asserted. It is protection from the assertion that the franchisee is the employee of the franchisor that is needed, and which we believe should be clearly provided in the Bill. To accomplish this, we believe that the definition in the Bill of "service" should be clarified to include the business operations of licensees and franchisees under contractual arrangements with licensors and franchisors to use the licensor's or franchisor's trademarks and business systems for a fee.

Assuming that this definitional hurdle can be cleared, either by amendment to the terms of the Bill or by clarification of the term "service" in a Committee Report, and franchisors are "service-recipients" under the terms of S.2369, we urge the Subcommittee to clarify in its report certain points regarding the application of the five-point safe harbor test to the franchise relationship.

In the first provision of the safe harbor test, "control of hours worked," we are concerned that the controls often imposed by a franchise agreement regarding the hours of retail operation, of the business may deprive a franchisee from enjoying the safe harbor. If a franchisor of a restaurant, muffler shop, hotel, or pet shop, for example, specifies that it must be open to the public during certain minimum hours, it should not deprive the franchisee of safe harbor protection. This type of contractual arrangement usually leaves an individual free to set his or her hours of working in the business, and this should qualify under the control of hours test of the Bill. Furthermore, if a franchise agreement requires that a business be open to the public for a minimum number of hours and requires that a franchisee lend his "best efforts" to the success of the operation, and also requires personal partici- pation in the management of the business, does this arrangement remove "control" by the individual franchisee? We think it should not, and we urge clarification by adding language which stresses that the individual "controls the aggregate number of hours the individual actually worked..." Our proposed language would assure that this section refers to individual control of individual work, and not the hours of a business operation.

The "place of business," "investment or income fluctuation," and "written contract" provisions of the Bill have clear application to the business operations of independent franchisees. The final test of the safe harbor provision, "filing of required returns," is awkward when applied to payments between franchisors and franchisees. Most franchisors pay their franchisees nothing; the flow of franchise fees runs in the direction of the franchisor. The franchised business operates independently, generating revenues from which a percentage is taken and forwarded to the franchisor. The filing requirement is therefore quite unclear under the proposed Bill, and may depend ultimately on whether, and how, a franchisor is defined as a "service-recipient."

Conclusion

The International Franchise Association supports the principles embodied in S.2369. We believe that the somewhat awkward application of its terms to the franchise relationship can be easily clarified by minor additions to the Bill and clear interpretations by the Subcommittee in its report to the full Committee. The independent nature of the franchisor-franchisee relationship is vital to this growing segment of the United States economy. The IFA applauds the efforts of Senator Dole and the Subcommittee in drawing a clear line between an independent contractor and an employee to prevent unwanted and unnecessary encroachment on these concepts by the Internal Revenue Service. Finally, we will be happy to provide any further comment or suggestions to the Subcommittee during its review of this legislation. We will be pleased to respond to any questions about the position set forth in this statement, or elaborate further upon it.

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Transmittal No. BY996:050582

May 5, 1982

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227, Dirkson Senate Office Building
Washington, D. C. 20510

Re: Monday, April 26, 1982 Hearing on Proposal S.2369
to Clarify the Tax Status of Independent Contractors

Dear Mr. Lighthizer and Members of the Subcommittee:

As an officer of a medium-size industrial construction firm active in the Southwestern United States, I felt compelled to share with you my thoughts on the above mentioned bill and its probable impact on our operations. I appreciate in principle the efforts of Senator Dole in attempting to provide some clarity in this area. Almost any change towards identifying or defining independent contractor status would be better than the existing common law definition which provides no reliable guidelines.

As I understand the principal parts of the bill, the "safe harbor" elective definition of an "independent contractor" provides, in part, that the worker must control the hours worked and scheduling of hours worked. In the contracting business, the number of hours worked and scheduling of hours worked is usually dictated by the owner or general contractor to integrate or coordinate several subcontractors' activities efficiently. Typically, the subcontractors or independent contractors have little flexibility in determining the total number of hours worked or scheduling of the hours worked.

In our work, the situation involving an independent contractor/individual worker would be the itinerant rig welder. These welders typically own their own diesel or gasoline-powered welding rigs as well as tools, light equipment, and consumables that are necessary to perform remote jobsite welding. Insofar as working on remote jobsites, all terms and conditions of the "safe harbor" independent contractor definition could be easily complied with, except for the control over the hours worked.

In conclusion, I stand in favor of the elective "safe harbor" definition for independent contractors. However, I respectfully disagree with the requirement that such definition include control of the aggregate number of hours worked and substantially all of the scheduling of hours worked. Such requirement is unduly burdensome to our typical business situation since we, as general or lead subcontractors, must coordinate and schedule the hours of our subcontractors/independent contractors as well as conform to the work hour requirements imposed on us by the owners or general contractors who hire our services. The "control over hours worked" provision would effectively negate any relief or utility of the elective definition, leaving us with the indefinite, common law definition. I urge your subcommittee to recommend deletion of this requirement.

Please keep me advised as to the progress of this bill or any additional information which may alleviate or relieve my concerns about this bill. Thank you for your time and this opportunity to provide my comments on this proposed legislation.

Very truly yours,

BOWEN INDUSTRIES, INC.

Bruce Yetter

Bruce Yetter
Vice President

BY:ho

[illegible]

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May 7, 1982

MEMORANDUM REGARDING INCLUSION OF EMERGENCY ROOM PHYSICIANS IN THE PROPOSED SAFE HARBOR RULES FOR INDEPENDENT CONTRACTORS

This memorandum discusses the status of emergency room physicians as independent contractors and the need for safe harbor legislation protecting their status. While this memorandum refers to certain cases and rulings, it is not intended to be a legal analysis.

I. General Summary of Emergency Room Practice

Many hospitals are unable to staff their emergency room facilities with qualified emergency room physicians, and, therefore, if these hospitals are to be full-service hospitals, it is advantageous for them to contract for emergency room coverage with outside physicians. This coverage may be for weekends, night shifts (6 p.m. to 6 a.m.), and sometimes on a full 24-hour basis.

Emergency medicine is a recognized medical specialty that has been developing during the past ten years. This specialized practice is particularly beneficial to rural areas that many times are otherwise unable to obtain qualified emergency room coverage.

Our client, Spectrum Emergency Care, Inc. ("Spectrum"), is one of a number of organizations that contract with hospitals to provide them with physicians for emergency room coverage. Generally, these hospitals are §501(c)(3) organizations, although some are for profit (5%-10%). Spectrum services approximately 250 hospitals in 33 states. In many instances, the hospital's costs of obtaining emergency room coverage through Spectrum, including stand-by costs, is reimbursable through Medicare. There are approximately 5,300 short-term general hospitals with emergency rooms in the country of which over 800 use groups like Spectrum. Spectrum has contract arrangements with approximately 2,000 physicians. Spectrum annually serves in excess of one million patients and provides approximately 1.3 million hours of physician coverage, approximately 75% of which is in non-urban areas.

After a contract with a hospital is obtained, Spectrum will contract with qualified emergency room physicians to provide the hospital with coverage. Virtually all these physicians (approximately 90%) have other medical practices.

Physician Contracts. In contracting with Spectrum, the emergency room physicians are free to choose and change the number of hours they want to work and what periods of time they want to work within the times specified in Spectrum's contract with the hospital. The physicians are also free to subcontract with other qualified physicians to substitute for them. Emergency room physicians are usually paid a fee on an hourly basis because the nature of emergency room facilities rests upon having qualified physicians available, rather than the number of patients seen or the amount of billings.

The contracting physicians are not eligible for the hospital fringe benefits generally accorded regular hospital employees; nor are these physicians provided the fringe benefits generally available to Spectrum employees. These physicians as a group are named as additional insureds under Spectrum's general malpractice insurance coverage. This method of insurance coverage is utilized because of the cost savings due to group coverage over individual coverage of each contracting physician. Naming the physicians as a group as additional insureds under Spectrum's general malpractice insurance policy is at no additional cost to either Spectrum or the individual physicians contracting with Spectrum. Many of these physicians (approximately 95%) are also covered under other policies of malpractice insurance.

The contracting emergency room physician, like most physicians, other than certain company doctors and certain resident hospital physicians, has been traditionally viewed as an independent contractor by the contracting hospital, the contracting physician and Spectrum.

II. Review of Law

Current State of the Law. Under current statutory law, there are no clear guidelines as to whether emergency room physicians are independent contractors or employees and if they were employees, whether they would be employees of groups like Spectrum or of the contracting hospital. There is no case law or published revenue ruling determining whether an emergency room physician is an employee or independent contractor. As a group, the practicing emergency room physicians have traditionally viewed themselves as independent contractors because they view this practice as part of their general practice and receive none of the benefits normally accorded hospital employees.

Treasury Regulations. Under existing law, the basis for determining whether a particular worker is an employee or independent contractor is determined under the common law test of control. Under that test, emergency room physicians have generally viewed themselves as independent contractors because they control their work. This is also in line with Treas.Reg. § 31.3401(c)-1(C) which provides that:

> "Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees."

Until recently, it was believed that the Internal Revenue Service also agreed that emergency room physicians were independent contractors.

Cases and Rulings. While there are no cases or published rulings establishing whether emergency room physicians should be treated as employees or independent contractors, there are cases and published rulings which tend to lend support to the emergency room physician's status as an independent contractor. See, for example, *Azad v. United States*, 388 F.2d 74 (8th Cir. 1968) and Rev.Rul. 66-274, 1966-2 C.B. 446.

In Rev.Rul. 72-203, 1972-1 C.B. 324, the Internal Revenue Service set forth the following four factors for determininng whether a physician should be classified as an independent contractor or as an employee: (1) the degree to which the physician has become integrated into the operating organization; (2) the substantial nature, regularity, and continuity of the physician's work for the firm or person involved; (3) the authority reserved by the person or firm to require compliance with its general policies; and (4) the degree to which the physician has been accorded the rights and privileges generally established for the firm's employees. We believe that under these guidelines the emergency room physician should be classified as an independent contractor. It is important to observe that in the above ruling, no special emphasis was placed on the form of compensation.

Notwithstanding the general view that emergency room physicians should be treated as independent contractors, in a private letter ruling dated October 27, 1978, Letter Rul. 7904109, the

Internal Revenue Service concluded (we believe erroneously) that certain physicians working under circumstances somewhat similar to the Spectrum contractual arrangement were employees, not independent contractors.

However, both before and after the issuance of the above private letter ruling, and notwithstanding its existence, the Internal Revenue Service, to the best of our knowledge, has on audit consistently permitted emergency room physicians to be treated as independent contractors. This is due in part to Internal Revenue Service examining agents finding a "reasonable basis" for independent contractor status under the Revenue Act of 1978 (Section 530, P.L. 95-600, as amended by P.L. 96-167 and P.L. 95-600, as amended by P.L. 96-167 and P.L. 96-541).

III. Application of Factors

In support of independent contractor treatment for emergency room physicians are the following factors: each emergency room physician has a professional degree; most physicians are traditionally treated as independent contractors; the emergency room physician controls the way in which he works; he is not well integrated with the hospital or Spectrum; he does not have rights, privileges or fringe benefits of either Spectrum or the hospital; he is free to select his own hours; he has a non-exclusive arrangement with Spectrum; and he is free to contract with other hospitals and organizations like Spectrum, and to have his own private practice.

On the other hand, the emergency room physician is usually paid a fee on an hourly basis, he does his emergency room work on the hospital premises, and in some cases agrees by contract to work at a set number of hours.

On balance, while the application of these factors supports independent contractor status, this conclusion is not free from question because of the ambiguities under present law. Furthermore, if for any reason the physicians were treated as employees, there is no certainty whether they would be treated as employees of Spectrum or employees of the hospitals in which they provide emergency room services.

IV. Disadvantages of Employee Status

Insuring that emergency room physicians will continue to be treated as independent contractors will help to prevent hospital and other medical care costs from further escalation, as would be the case if the Internal Revenue Service were ultimately successful in determining that these individuals were employees and not independent contractors. For example, if these individuals were treated as employees, there would be additional expenses, which expenses would include additional employment taxes, additional malpractice coverage, and fringe benefit coverage normally provided employees, including medical, life insurance, and pension and profitsharing benefits that may be required to be paid on these individuals' behalf. These additional expenses would substantially increase the cost to the hospitals for the emergency room coverage provided by groups like Spectrum which cost ultimately would be borne by the hospital patients, and to an extent by both Federal and state governments (e.g. Medicare, Medicaid, other government medical insurance costs).

V. Conclusion

We strongly believe that because of the current uncertainties in the treatment of emergency room physicians, that this is a situation that should be addressed by any proposed safe harbor legislation. We have attached hereto suggested legislation that would provide a safe harbor for those hospital physicians which have historically been considered independent contractors and not employees.

Statistical studies also show that these physicians are within that group of taxpayers who consistently pay their taxes and are not within that group of taxpayers who have used independent contractor status as a means to avoid the tax reporting requirements.

Because of the unique nature of the emergency room practice, it does not fit within the proposals made under S. 2369. Quality emergency room medical care requires the continuous availability of emergency room physicians and continuity in scheduling. These factors should not adversely affect the emergency room physician's status as an independent contractor. Special limiting legislation is therefore required for these professionals.

Furthermore, while emergency room physicians who are not regular employees of the hospital have been traditionally treated as independent contractors, there is concern that the Internal Revenue Service may take a much harsher stance with respect to those individuals who do not fall within the safe harbor requirements of the legislation, notwithstanding contrary language in the proposed bills. Since it is the intent of the safe harbor legislation to avoid conflict situations where possible, provision should be specifically made in the legislation for emergency room physicians. We respectfully suggest language such as that in the attached proposed bill.

A BILL

To amend the Internal Revenue Code
of 1954 to provide that certain
hospital physicians may be treated
as independent contractors for
purposes of the employment taxes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Chapter 25 (relating to general provisions relating to employment taxes) is amended by adding at the end thereof the following new section:

"Sec. 3509. Certain Individuals Providing Medical Services in Hospitals.

"(a) General rule. - For purposes of this subtitle, if the requirements of subsection (b) are satisfied, an individual rendering medical services in a hospital shall not be treated as an employee of either the hospital or of any person (other than a corporation in which the individual owns, directly or indirectly, within the meaning of section 318(a), 10 percent or more of the total combined voting power of all classes of stock of such corporation) who arranges for the individual to render the medical services in the hospital.

"(b) Requirements. - The requirements referred to in subsection (a) are as follows:

(1) The individual providing medical services in the hospital is a licensed physician, entitled to practice medicine in the state where the hospital is located; and

(2) The hospital, or the person arranging for the individual to render the medical services in the hospital, if any, and the individual agree in writing, before the later of (A) the date the services are to be first rendered or (B) [60 days after the date of enactment of this Act], that the individual is to be treated as an independent contractor, and not an employee, with respect to the hospital and the person arranging for the individual to render the medical services in the hospital, if any.

"(c) Effect on Subtitle A. - If all the requirements of subsection (b) are met with respect to service performed by an individual, such individual shall not be treated as an employee of the hospital or of the person placing the individual in the hospital, if any, for purposes of applying any provision of subtitle A."

Section 2. The amendments made by this Act shall take effect with respect to payments made after June 30, 1982.

Record 26

HOME HEALTH SERVICES
and STAFFING ASSOCIATION

May 10, 1982

The Honorable Charles E. Grassley
Chairman, Subcommittee on Oversight
of the Internal Revenue Service
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Home Health Services and Staffing Association wishes to present its views to the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance on S. 2369, the "Independent Contractor Tax Classification and Compliance Act of 1982." We request that this letter be incorporated into the record of the Subcommittee's April 26, 1982, hearings on this proposed legislation.

Members of the Home Health Services and Staffing Association (HHSSA) are investor-owned, tax-paying organizations, which provide both home health care services and supplemental nursing services through over 1,000 offices in 44 states.*/ In 1979, our members employed more than 160,000 persons in either a full-time or part-time capacity. In order to be eligible for membership in HHSSA, an entity must assume the legal obligations of an employer with respect to the professional and other personnel utilized in providing supplemental nursing services to hospitals, nursing homes and other institutions and home care services to individual patients. These obligations include the payment of FICA and FUTA taxes, workers' compensation and federal and state withholding.

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*/ Our members are: Alpha Nurses; American Medical Personnel Services, Inc.; Health Extension Services, Inc.; Kelly Health Care, Inc.; Kimberly Nurses; Manpower, Inc.; Medical Personnel Pool; Medox; Norrell Corporation; Nursefinders; Nurses PRN, Inc.; Olsten Corporation; Professional Nurses Bureau, Inc.; Quality Care-USA, Inc.; S.R.T. Med-Staff International; Staff Builders; Temporaries, Inc.; and Upjohn HealthCare Services, Inc.

Suite 800/2101 L Street, N.W./Washington, D.C. 20037 Telephone: (202) 775-4707

We wish to comment on S. 2369, because of our concern about the practices of certain businesses providing medical personnel services which improperly assert that their personnel are "independent contractors" and thus avoid the legal obligations of employers. In order to appreciate these concerns an understanding of the business practices of supplemental nursing services is necessary.

A supplemental nursing service (SNS) recruits and employs nurses and other health care personnel for the purpose of providing the services of such personnel to its clients, usually on a temporary basis. The SNS/Client arrangement usually falls within one of the following categories:

1. A health care facility utilizing SNS personnel to supplement and work along with, and as a part of, its regular staff.
2. A health care facility utilizing SNS personnel as special duty nurses for a particular patient.
3. An individual utilizing SNS personnel as private duty nurses, either at home or while in the hospital.
4. In some cases, an individual utilizing SNS personnel to provide a wide range of home care services, including nursing and other paramedical services authorized by a physician's plan of treatment and organized and supervised by SNS supervisory staff.

In all of these arrangements, the SNS assumes and exercises all of the attributes of an employer under common law. Of course, in the case of a facility utilizing SNS personnel to supplement its permanent staff, day to day supervision of SNS personnel is undertaken by the facility. Nevertheless, in every case, the SNS pays wages and bills its clients a service fee that covers all of the SNS' costs of doing business.

An SNS undertakes all of the obligations of an employer with respect to its personnel, including the following:

1. Determine pay rates and pay wages.
2. Withhold and pay all employee and employer payroll taxes required by federal, state and local law.

3. Pay premiums and provide coverage under all state workers' compensation, unemployment compensation and disability laws.

4. Provide various forms of fringe benefits, including sick leave, vacations and health insurance.

5. Provide various types of liability and bonding insurance covering its employees' activities.

6. Provide various types of orientation training and in-service programs.

7. Establish employment criteria and disciplinary policies and procedures.

8. Monitor and evaluate employees, and depending on the circumstances, undertake supervision of employees on assignment to clients.

From the above description, it can be seen that the working relationships in our industry almost always involve three parties:

-- the worker who performs the service;

-- the SNS which assigns personnel to a client's facility, exercises control over the worker, and pays the wages; and

-- the facility or individual client who receives the services, also may exercise control over the worker, and pays a service fee to the SNS.

Our concern is that some firms providing medical personnel services, characterizing themselves as "personnel referral agencies" rather than "supplemental nursing services", are using this three party relationship as a basis for claiming that their personnel are "independent contractors".

These "personnel referral agencies" often enter into arrangements with clients which are virtually identical to those described above. The typical example involves a firm that recruits nurses or other health care personnel for temporary assignment as supplemental staff to a health care facility. The facility client is billed a service fee based on the hours worked by such personnel. The "personnel referral agency" pays wages to the personnel, also based on hours worked. Neither entity, however, withholds or pays payroll taxes, workers' compensation, or unemployment insurance premiums on behalf of the "independent contractors."

The "personnel referral agency" may enter into written agreements with the personnel and/or facility client, which describe its function as "providing a referral, billing and payroll service" for the individual worker. We know of some firms which even give personnel the option of being treated as "independent contractors" or as "employees" subject to tax withholding. Others maintain two separate but related businesses -- one to recruit and assign "independent contractors" and another to recruit and assign "employees" -- in both cases to the same types of clients.

In the foregoing examples, the personnel cannot be considered as "independent contractors", even under the most liberal common law tests. We believe that one or both of the other parties to such arrangements are "employers" under common law and that withholding and other tax and related payment responsibilities should rest either with the facility, which exercises the right of supervision and control, or the "agency", particularly if it pays the wages.

A distinction can be made between arrangements involving a health care facility and those involving private patients. In the absence of control and supervision by a health care facility, a licensed registered nurse or other skilled professional, by virtue of training and experience, may well be able to function as an independent contractor. Normally, such services are arranged through a Nurses Registry established under state law.

However, a lesser skilled worker -- such as a companion, sitter, home health aide or homeworker -- probably lacks the training and experience required to determine and control independently the manner and method of his or her experience. When such an individual performs services for a private patient, therefore, it is reasonable to assume that either the patient or the "agency" is exercising sufficient control to characterize the worker as an "employee" under common law tests.

S. 2369 appears to be designed to address the conventional two party working relationship between a worker and the entity which receives and pays for the service. It is unclear how the bill's provisions would apply to the three party arrangements which characterize supplemental staffing services. HHSSA is therefore apprehensive that these ambiguities might result in the unintentional extension of independent contractor safe harbor treatment to the types of arrangements previously mentioned.

Some of the provisions of the bill's safe harbor test which create confusion when applied in the supplemental staffing context include:

-- the definition of "service recipient" in Subsection (c)(1) of the proposed Code Section 3508;

-- the special rule concerning control over the scheduling of hours where a contract exists between the "service recipient" and a third party in Subsection (c)(4)(B);

-- the special rule for determining the "principal place of business" in Subsection (b)(2)(B); and

-- possibly, the definition of "output" in Subsection (b)(3)(B)(ii) to be used in determining the income fluctuation test. Furthermore, the proposed Code Section 6041A concerning information returns also fails to take into account three party relationships.

Numerous technical clarifications would be required to convert the proposed legislation into a suitable vehicle for addressing supplemental staffing relationships. HHSSA does not believe that it is the intent of the Subcommittee to extend independent contractor safe harbor treatment to personnel working within these relationships. We therefore suggest that the more efficient solution would be to clarify in the bill -- or at the minimum, in legislative report language -- that the safe harbor test only applies to the relationship between a worker and the hospital, nursing home or private patient client which actually receives the services. It would be necessary to state clearly that the enactment of this legislation would not affect or prevent a finding that, for tax purposes, such a worker is an employee of another entity which either controls or pays wages to the worker.

Clarification that safe harbor treatment does not extend to the relationship between a worker and a supplemental staffing service would be consistent with the view that a safe harbor standard for independent contractors should be confined to those situations where an individual is truly engaged in a business enterprise, such that his net income may be significantly different from his gross income as a result of investments or unreimbursed expenses. In these situations, imposing withholding and tax liabilities on any entity other than the worker would be clearly inappropriate.

Finally, HHSSA endorses the proposal of the Department of Treasury made in testimony before the Subcommittee that the "anti-switching" rule provided in Section 4(a)(2)(B) of S. 2369 be given permanent application in order to protect workers formerly treated as employees for tax purposes prior to enactment from being converted by their employers into "independent contractors" as a result of the new legislation.

In conclusion, HHSSA wishes to express its appreciation to the Subcommittee for the opportunity to present written comments on this proposed legislation, which is of direct importance to the supplemental nursing service industry. We hope to work with the Subcommittee staff in resolving the problems we have identified.

Sincerely,

John B. Smith

John B. Smith

cc: The Honorable Robert J. Dole
Chairman, Committee on Finance
U.S. Senate

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STATEMENT
on
THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND
COMPLIANCE ACT (S. 2369)
for submission to the
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Rachelle B. Bernstein*
April 26, 1982

The Chamber of Commerce of the United States, representing over 240,000 businesses, trade associations, and local and state chambers of commerce welcomes the opportunity to submit testimony on S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982.

Summary

The Chamber commends Senator Dole on his proposed legislation dealing with the difficult problem of classifying workers for tax purposes as employees or independent contractors. Important tax consequences result from this classification, and S. 2369 provides certainty in making that classification by establishing a "safe harbor" test that businesses can rely upon to ensure that individuals providing services to them are self-employed independent contractors. The Chamber supports this legislative effort which adequately deals with the independent contractor problem without requiring withholding.

Nature of the Problem

A significant difference exists under current law between the tax treatment of employees and independent contractors. An independent contractor does not have

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*Senior Tax Attorney, Tax Policy Center, Chamber of Commerce of the United States

Federal Insurance Contributions Act (FICA) taxes or income taxes withheld from his or her remuneration, but must make these payments directly to the Internal Revenue Service (IRS). The business that uses an independent contractor is not liable for tax under the Federal Unemployment Tax Act (FUTA), or for the employer's share of FICA taxes, and also avoids the administrative burden of withholding.

Under present law, an individual is considered an employee for withholding purposes if the common law relationship of employer/employee exists. The income tax regulations define this relationship in the following manner:

> Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. Treas. Reg. Section 31.3401(c)-1(b).

Thus, the determining factor under the common law test is the degree of control which the employer has over the worker.

The definition of employee for purposes of social security and federal unemployment taxes is virtually identical. The only major difference is that persons engaging in certain occupations are classified by statute as employees for social security tax purposes, regardless of how they would be treated under the common law test.

Even though the common law test has existed for many years and has been the subject of numerous court decisions, there are no clear and concise rules for deciding what degree of control is enough to make an individual an employee.

For example, the Internal Revenue Manual, which gives guidance for Internal Revenue agents involved in the audit process, contains a list of twenty factors, based on common law, which agents consider in making this determination. None of these factors is controlling, nor is the fact that a majority of them would indicate that a given individual should be classified as an independent contractor.

The lack of certainty in the common law test can be particularly hard on the business or individual paying for the services (the payor). It is the payor who must decide whether the person performing the services is an employee or independent contractor. If the payor decides the person is an employee, then the payor must generally withhold income and social security taxes from the amounts paid out and pay the employer's share of social security taxes and the federal unemployment taxes. If the payor decides the person is an independent contractor, the payor has no responsibility to withhold or pay employment taxes. The person receiving the payments, the payee, then has the direct responsibility for paying income and social security taxes directly to the IRS.

The consequences of mistaken classification can be serious. If a business has individuals reclassified as employees, that business would owe the income and social security taxes it should have withheld, along with the employer's share of social security taxes and federal unemployment taxes for all years not barred by the statute of limitations. The business would be able to reduce the amount due for the income taxes it should have withheld only if it can obtain sworn affidavits from the reclassified workers stating that they had paid their income taxes. The social security taxes paid by an independent contractor under the Self-Employment Contributions Act (SECA) cannot be used to offset the employer's share of social security taxes. The reclassified worker may request a refund of the excess of social security funds, but no effort is made by the IRS to notify the worker of this right.

The effect of reclassification may extend beyond employment tax problems. The law permits an independent contractor to establish a Keogh plan and contribute up to $15,000 a year into that plan, as well as contribute up to $2,000 a year into an individual retirement account (IRA). In addition to an employer-sponsored pension plan, an employee may establish only an IRA, which has a basic contributions limit of $2,000. An IRS determination that an individual is an employee would mean the earlier contributions to a Keogh plan were improper and, therefore, not tax deductible. It might also mean a reduction in the potential retirement savings of that individual.

A business could suffer a similar fate. ERISA requires that certain percentages of a firm's employees be included in a retirement plan in order for contributions to be tax deductible. The sudden reclassification of a number of individuals to employee status could cause disqualification of the plan. The additional costs of bringing the newly classified employees into the plan may cause the business to abandon it altogether.

In the late 1960's and early 1970's, the IRS increased its enforcement of the employment tax laws. Reclassification by the IRS from independent contractor to employee status resulted in large tax liabilities for many businesses which had traditionally treated their workers as independent contractors.

The Revenue Act of 1978 provided temporary relief from the effects of retroactive IRS employment tax audits to persons who, acting in good faith, had treated the individuals performing services for them as independent contractors. The act terminated pre-1979 employment tax liabilities for these taxpayers and also prohibited the IRS from issuing any new rulings or regulations on this issue until January, 1980. This moratorium on the issuance of rulings and regulations by the IRS was later extended to June 30, 1982.

Legislative Solution

The Chamber supports creation of a broad "safe harbor" test, codifying the standards which evolved under common law and providing relief from the uncertainty created by IRS interpretation of the common law test. S. 2369 achieves this goal. The bill would not change the reasoning behind the classification of workers as either independent contractors or employees under the common law test. The amount of control exercised by the person for whom services are performed would still determine the proper classification. The bill would merely provide the self-employed and the business using the self-employed with a guarantee that, where the standards are met, the IRS would treat the worker as an independent contractor. Consequently, taxpayers would be relieved from IRS retroactive reclassification of independent contractors as employees which would result in retroactive assessment of employment taxes, double taxation where taxpayers paid withholding assessments for the same liabilities for which workers had paid income tax, overpayments of social security taxes where taxpayers pay FICA taxes with respect to workers who had paid SECA taxes, and disqualification of retirement plans.

The Chamber opposes imposition of withholding on independent contractors. Withholding does nothing to help a business solve the real issue -- determining whether an individual is an employee or an independent contractor.

CONCLUSION

Many businesses and individuals have relied for years on the belief that the common law test established the individuals' tax status as independent contractors. Assertions by the IRS that many of these individuals were instead employees has brought increasing uncertainty to the common law test. Although the moratorium on IRS issuance of regulations and rulings in this area has provided a temporary solution to this problem, we hope that a permanent legislative solution can now be achieved.

We commend this subcommittee for holding hearings on this issue and extend the Chamber's support for legislation, such as S. 2369, creating a "safe harbor" test which provides certainty without extending independent contractor status to persons presently classified as employees and without imposing a new withholding system on independent contractors.

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STATEMENT OF
THOMAS J. MCHUGH
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE THE
COMMITTEE ON FINANCE
U.S. SENATE
MAY 10, 1982

My name is Thomas J. McHugh. I am Vice President-Taxes of Dart & Kraft, Inc. and am testifying today on behalf of the National Association of Manufacturers. NAM represents nearly 12,000 member firms who account for nearly 80% of the nation's industrial output and 85% of the nation's industrial workforce. As Chairman of the NAM's Taxation Committee, I am pleased to offer the Association's views on the classification of persons as employees or independent contractors.

INTRODUCTION

As you might imagine, NAM's members contract with very large numbers of self-employed persons providing the entire range of goods and services from raw materials to final sales. Consequently, the NAM is acutely interested in issues presented by the classification of workers as employees or independent contractors.

The ultimate object of these hearings is legislation providing taxpayers and the Treasury with much needed guidance on the classification of persons as either independent contractors or employees. It should be noted at the outset that this need relates to income withholding and payroll tax purposes only, and we think any legislative resolution should be expressly restricted to these areas.

The three taxes at issue are:

(1) Social Security taxes under either the Federal Insurance Contribution Act (FICA) for employees or the Self-Employment Contribution Act (SECA) for independent contractors;

(2) Unemployment taxes under the Federal Unemployment Tax Act (FUTA); and

(3) Withholding under the general income tax.

Effects of Classification

If a person is classified as an employee, the employer is liable for the employer's share of the FICA tax, presently 6.7% of the first $32,400 in wages. The employer must also withhold from the employee an equal amount as the employee's share. Also, a FUTA tax is imposed on the employer at the rate of 3.4% on the first $6,000 of wages (minus a state tax offset). Finally, employers are required to withhold a portion of wages to satisfy an employee's income tax liability.

If a person is classified as an independent contractor, such person must pay a SECA tax of 9.35% on the first $32,400 of net earnings (as opposed to gross wages). Neither the contractor nor his payor have any FUTA or income tax withholding obligations. However, for income tax purposes the contractor will likely be required to file a declaration of estimated tax and periodic tax payments. Payors engaged in a trade or business generally must file information returns with respect to payments of $600 or more in a year. These returns are filed on an annual basis and payors must account for cumulative amounts during the year.

The Administration and others have contended that there are strong incentives for both payors and payees to classify workers as independent contractors. The lack of a FUTA tax, the absence of withholding obligations and a combined employee-employer FICA tax higher than the SECA tax may tend to result in a shift of questionable workers from the employee to the independent contractor category. However, the risk of reclassification of workers as employees by the IRS and the appurtenant back taxes, penalties and interest may well obviate any incentive for payors to do so.

Present Status

The controversy in this area has in large part resulted from increased activity by the Internal Revenue Service's employment tax compliance program. Since the late sixties, the Service has been increasingly aggressive in its attempts to reclassify workers as employees. These reclassifications under audit have an essentially retroactive effect and have presented many businesses with huge unforeseen back liabilities.

These reclassifications have also threatened the qualification of certain retirement plans. For example, a previously qualified retirement plan could fail to meet maximum coverage requirements if certain workers were reclassified as employees and persons who set up self employed (H.R. 10) plans could find those plans disqualified.

This increased activity by the IRS has been the prime reason for a series of interim relief provisions, beginning in 1978, under which the Treasury has been prohibited from issuing new regulations or rulings in this area. The most recent such moratorium expires on June 30, 1982. The purpose of this interim relief was to allow the Congress sufficient time to consider a resolution of the independent contractor status controversy.

Classification of Workers

It is important for the committee to segregate the immediate and longer term problems in the independent contractor area. The single most pressing need now is for legislative clarification on the proper classification of workers as either employees or independent contractors. The NAM is concerned that attempts to address important but less critical matters may lessen the chances for passage of the essential guidance on classification. For example, questions of social security funding, SECA tax rates, and withholding proposals should take a subordinate priority to legislation which will assure payors of some certainty in the employment tax area.

In the absence of legislation providing some measure of employment tax certainty, no company can budget, predict, or price its product with reasonable expectations of what its ultimate tax liability will be. These concerns are even more acute for smaller businesses which do not have the cash reserves or the access to credit of larger firms.

Consequently, the NAM supports the safe harbor provisions of S.2369 introduced by Senator Dole (R-KS). The "safe harbor" approach of the bill will allow most companies to predict with a fair degree of certainty what the extent of their employment tax liabilities will be.

The classic incidence of the independent contractor relationship in the manufacturing community is that of the manufacturer's representative. Representatives will usually provide services for several manufacturers, but they will typically stay within related industrial groups. Nearly without exception, the representative will control the hours worked and will not have a principal place of business provided to him by the service recipient. As a result, representatives satisfy the first two of S.2369's five requirements.

While a representative's investment in assets used in connection with the performance of services may in certain instances be less than the substantial amount required, the bill's alternative test of income fluctuation would clearly be satisfied by the standard commission relationship between the manufacturer and his representative.

The existing manufacturer-representative relationship will not be disturbed by S.2369, provided that the parties comply with the fourth requirement of a written contract and notice of tax responsibility. While this new requirement would be something of an administrative burden, it is an acceptable one in order to achieve the certainty and predictability needed in the withholding and payroll tax areas. NAM sees no problem with the fifth requirement of filing of information returns.

The five part safe harbor test will not identify all independent contractors. Those independent contractors that are not able to achieve that status through the safe harbor approach will still be able to qualify as independent contractors under common law principles. NAM believes that the alternative of classification under common law is an integral part of any solution and should be retained as part of any final legislation.

Taxpayer Compliance

S.2369 contains several provisions that are designed to improve compliance among independent contractors. While NAM is encouraged by the fact that this legislation seeks to deal with taxpayer compliance without resorting to withholding on independent contractors, we are concerned that the proposed penalties are unduly harsh. While reporting may be the keystone of improved compliance, the NAM believes that adequate sanctions exist in current law to deal with those service recipients that fail to file information returns. If these sanctions are deemed inadequate, then we suggest a dollar limit on first offenses.

While NAM supports the rationale for increased penalties for multiple offenders, a surcharge for de minimis violations such as incomplete reports and late filings is excessive and punitive. NAM contends further that the sliding scale penalty proposed by this legislation is a complex and inefficient way to deter multiple offenders. A simpler and more effective remedy would be a fixed penalty for multiple offenders.

Procedural Matters

The NAM is appreciative of Senator Dole's comments regarding the reclassification of independent contractors. We, too, are concerned about the vast majority of businesses that in good faith and with reasonable cause decided to classify certain workers as independent contractors. Many of these same firms may soon face the reclassification of certain workers as employees and may confront a substantial retroactive assessment. The NAM, therefore, proposes that a specific dollar limit be imposed to prevent large retroactive assessments where a reasonable basis existed for the classification of a worker as an independent contractor. The NAM also believes that there should be taxpayer access to the Tax Court to contest IRS reclassification or to some other judicial forum that does not require the payment of disputed taxes as a pre-condition to litigation.

STATEMENT FOR THE RECORD
OF THE
AMERICAN PETROLEUM INSTITUTE
STATEMENT CONCERNING
LEGISLATIVE PROPOSALS RELATING TO INDEPENDENT CONTRACTORS

This statement is submitted on behalf of the American Petroleum Institute.

The API welcomes the initiative evidenced in legislation concerned with the proper tax treatment of either employer/employee or principal/independent contractor relationships with respect to payroll taxation and income tax withholding. The Bill introduced seeks to relieve the chaotic situation which currently exists in regard to this issue. However, because of the short period between the time S. 2369 was introduced and the time the moratorium on action by the Internal Revenue Service will expire, and in light of the additional issues presented in the bill, the moratorium should first be extended to allow for careful analysis of the new provisions. Specifically, the withholding requirements relating to certain payments to independent contractors and the penalty provisions should not be approved.

Internal Revenue Service Activities Giving Rise to the Need for Legislation

In a departure from existing case law and rulings, the Internal Revenue Service has taken actions which impose severe hardships on many businesses and individuals by dramatically altering the application of the withholding provisions of the Internal Revenue Code and of the requirements of the Federal Insurance Contribution Act (FICA) and the Federal Unemployment Tax Act (FUTA).

Specifically, the Service has sought to reclassify as "employees" many persons who traditionally have been treated as independent contractors. The problem has been further exacerbated by the retroactive imposition of taxes and penalties as a result of such reclassifications.

The 96th Congress passed H. R. 6975 (P. L. 96-541), which extended through June 30, 1982, a ban on the Internal Revenue Service issuing regulations which would have the effect of reclassifying independent contractors as employees; thus allowing the 97th Congress sufficient time to enact dispositive legislation which will provide proper guidance for the determination of employer/employee status under the Internal Revenue Code.

Additional Considerations Pointing to the Need for Prompt Action by the Congress

If Congress does not legislate an equitable resolution to this problem or fails to extend the moratorium, the continuation of the past practices of the IRS will adversely affect the business community in the following ways:

(1) Many businesses will become subject to additional FICA and FUTA taxes and will also be subject to the withholding requirements for Federal income taxes and the employee's share of Social Security taxes.

(2) The retroactive imposition of taxes and penalties as a result of reclassification will, in some cases, result in the duplicate payment of these taxes thus jeopardizing the solvency of many small businesses. Frequently, the taxes imposed upon the employer as a result of reclassification have already been paid by the newly designated employee in his previous status as an independent contractor. This problem is aggravated by the policy of the IRS not to search its records to ascertain whether or not the claimed withholding taxes have already been paid by the person who has been reclassified.

(3) The IRS reclassification of a large number of independent contractors as employees could have substantial impacts on both company-sponsored retirement benefit plans and the Keogh Plans or Individual Retirement Accounts of the reclassified individuals. Under current laws, some of these impacts are as follows:

(a) The tax-qualified retirement plan of the employer could be disqualified.

(b) In order to prevent disqualification of the employer's plans, the reclassified individuals would have to be brought into them retroactively. This would create many actuarial and benefit determination problems, together with large funding deficits.

(c) In case of either (a) or (b), these reclassified individuals who had been taking deductions for contributions to Keogh Plans or Individual Retirement

> Accounts could have these plans disqualified. Their deductions could be recaptured with tax, interest, and penalties assessed. In some cases, the terms of these individual plans would remain in force, preventing the individuals from drawing on these funds to meet the assessments. The financial effect on such an individual would be devastating.

For the foregoing reasons, it is imperative that this Congress act promptly to resolve this most important issue.

Proposals of the General Accounting Office (GAO)

In its Report Number GGD-77-88, the GAO accurately described the chaotic situation existing in regard to classification of the individual worker. To remedy this, the GAO report proposed several recommendations which would alleviate some of the uncertainties and inequities arising in the application in this section of the Code. However, these recommendations conclusively classified an individual as an employee if at least three of its requirements were not met. They failed to permit the application of the common law test in all situations outside the "safe harbor" definition prescribed for the independent contractor. S. 2369 makes the common law test automatically applicable when the facts do not precisely fit the "safe harbor". The GAO, in a statement by Daniel F. Stanton, Deputy Director, before the Subcommittee on Oversight of the IRS on S. 2369, supported the two tier test of the bill. It is for this reason that we strongly favor the enactment of S. 2369 subject, however, to a few very important modifications.

The common law test has been an integral part of the law since the founding of the United States. It is relied on to establish many aspects of business and legal relations between people, including the relationship for determining liability for Federal employment taxes. Other examples include: coverage in and qualification of employee retirement plans and other benefit plans, the validity of Keogh plans, liability under tort law, and Government regulations on allocation and price controls of petroleum products. There is occasionally some difficulty in applying the test in marginal situations. However, the test is superior overall to the alternatives that have been suggested, and any change in the law would breed new areas of uncertainty and confusion. The common law test has withstood the test of time and should be retained.

The essence of the common law test is control. An employment relationship exists if the employer has the right to control not only the end product of the work but the moment-by-moment details of how the work will be performed. Independent businessmen are obviously not subject to such detailed control; they are motivated instead by individual initiative. If Congress permitted the law to be changed so that independent businessmen would be treated as employees for employment tax purposes, it can be expected they will eventually be treated as employees for other purposes, thus eliminating many independent businessmen and individual initiative. This could have a profound effect on the American economic system.

It is a fact that substantial problems have arisen in the administration of the employment tax laws. The problems are not inherent in the common law test. They result from efforts by the IRS to expand the definition of "employee" to cover independent businessmen, and the absence of adequate procedural and judicial remedies to protect taxpayers.

S. 2369 - A Good Beginning

We support the basic thrust of S. 2369, and commend its sponsors for their efforts to bring clarification to what has been a very confusing area of our tax law.

S. 2369 would establish a five-part "safe harbor" test which, if met in full, would result in an individual being classified as an independent contractor rather than an employee. To qualify as an independent contractor under the "safe harbor" test, a person must meet all of the following requirements:

(1) The person must substantially control his own work hours and work schedule.

(2) The person does not maintain a principal place of business or, if he does so, such main place of business is not provided by the person for whom he performs services, or the person pays a fair rent if such place of business is so provided.

(3) The person has a substantial investment in his own business or the person risks income fluctuations because his remuneration with respect to services is directly related to sales or other output rather than to number of hours worked.

(4) The service is performed pursuant to a

written contract which:

(a) was entered into before the performance of the service;

(b) provides that the person will not be treated as an employee for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and income tax withholding at source; and,

(c) the person is provided written notice of his responsibility with respect to the payment of self-employment and Federal income taxes.

This requirement will be deemed to be satisfied with respect to contracts entered into before January 1, 1983, if such contracts clearly indicate that the individual is not an employee (either by specifying that the individual is an independent contractor or otherwise) provided that such notice is given before January 1, 1983.

(5) The person for whom the worker performed services must file information returns (Forms 1099).

If the five factor "safe harbor" test is not met, the worker may still be classified as an independent contractor if he can meet the requirements of a "common law" test. As noted previously, this test focuses on the control exercised over the worker whose status is at issue. For example, a worker will not be treated as an employee unless the person for whom he performs services controls or has the right to control not only the result to be accomplished but also how that result is to be accomplished.

We submit that the approach taken by S. 2369 is the correct approach. It is in keeping with the recent statement of the Supreme Court in the case of Central Illinois Public Service Company v. U. S., 98 S. Ct. 917 (1978), wherein the Court said: "Because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific Congressional action, the employer's obligation to withhold be precise and not speculative."

The enactment of S. 2369 with modifications will provide precision and remove speculation with respect to the tax treatment of individuals who may be argued to be either employees or independent contractors under current provisions of the Internal Revenue Code.

Suggested Amendments to S. 2369

There are several situations and conditions not covered by S. 2369 which we feel could be alleviated by further reform by way of amendment or addition to the bill. We have attached to this statement suggested amendments to S. 2369 which cover some of these areas. The situations to which we would like to invite your attention are discussed below.

Of primary concern is the introduction of the additional penalties with respect to returns required under Section 6041A. This requirement is not necessary. First, the general penalty provisions applicable to all 1099 Forms already provide adequate penalties. Second, there is no need to clutter the definitional purpose of the bill, with these complicated penalty provisions. Finally, for the sake of administrative simplicity, all Form 1099s should have the same penalty provisions applicable as provided in Section 6652 of the Internal Revenue Code.

Considering that proposed new Code Section 6041A applies only to service recipients engaged in a trade or business and that such entities are already subject to the reporting requirements of Section 6041 and the penalty provisions applicable thereto, it does not seem reasonable -- merely because Service is involved -- to impose new or different penalties than would be applicable to a failure to comply with existing Section 6041.

The penalty of Proposed Section 6660(A)(2) and the special penalty (surcharge) of Proposed 6660(B) have all the marks of unfairness when compared with the penalties applicable to Section 6041. For example, the penalty which Section 6652 imposes for failure to comply with Section 6041A is $10 for each failure, with a maximum penalty of $25,000 for any one calendar year. Under Proposed Section 6660(a)(2), the penalty is 1 percent for each month the failure continues (but not in excess of 5 percent), multiplied by the amount required to be included in the return which was not included in the return. Under these provisions, the monetary penalty could be astronomical for making errors on just a few returns. If, say, only five returns of $100,000 each are missed, the penalty for these five could be as high as $25,000, and there is no limit. This should be removed.

Moreover, the very working of the surcharge could be highly discriminatory, as between taxpayers, because of its percentage basis. A taxpayer with a small number of information returns to be filed, each of which represented large amounts, and who erred (without establishing reasonable cause) on only a few such returns, but which represented a large percentage error, would be subject to a very large monetary penalty; whereas a taxpayer with a large number of returns to be filed, but with an error factor of 10 percent or less, would incur no surcharge. In general, we feel that the penalty provisions of S. 2369 are much too harsh and too complex.

API believes that under no circumstances should a payor be required to withhold amounts on payments to independent contractors. If a qualified payee fails to provide a required identification number or provides an incorrect one, he, and he alone, should bear the consequences of his action. The payor should not, because of the payee's inadvertence, be put to the administrative effort of having to withhold from his remittance (with all the accompanying accounting problems, deposits, and reporting to IRS). At most, the payor should be expected to report the payee's failure to IRS for its follow-up in a manner similar to an employer's obligation to report invalid W-4 forms received from employees. Withholding from a remittance to a payee, with all its accompanying consequences, is not a small chore for the payor. If there is to be any special burden to be borne, it should rest where it belongs -- on the payee. In the case where an independent contractor supplies an erroneous identification number, it is clearly unfair to impose the withholding responsibility on the payor. How is he to know the number is incorrect? By the time the erroneous number is disclosed, the independent contractor could be no where to be seen. A payor should not become liable for the payee's taxes when the payee provides the erroneous information.

Irrespective of whether the safe harbor or common law tests are met the IRS should be prohibited from disqualifying retroactively the qualified pension, profit-sharing and employee stock ownership plans of the business or the reclassified individual as a result of a reclassification of non-employees as employees, where they have in good faith treated the individuals as non-employees for purposes of withholding taxes and participation in such plans. Retroactive application should only occur when fraud or bad faith has been practiced. Such retroactive disqualification does not serve the just administration of the tax laws, the private pension system, or most importantly the participants of the plans, whose rights are sought to be protected by the pension reform laws. The need to avoid retroactive disqualification of private plans takes on added significance when one considers the problems the Social Security System is facing today.

It would be helpful if the requirement of meeting all of the five criteria of independent contractor status be changed to four-out-of-five, in order to provide greater flexibility in qualifying under the safe harbor rules. One difficulty has always been the subjectivity involved in determining the type relationship which exists. Different individuals have different views of the facts. One possible alternative would be to have payee submit a statement certifying that the three subjective tests are met. Even the five criteria for a safe harbor, although a significant improvement, will leave considerable room for differences of opinion. Thus, having to meet only four of the five criteria will make it easier for divergent opinions to be reconciled on the broader concept of a safe harbor rule. The five out of five requirement places a significant burden on the payor to determine such subjective elements as "significant" value of assets, "substantial" investment, "principal" place of business, "substantial" control of hours. It is too much to ask of an individual to determine beforehand that all five requirements are in fact met.

We feel that an objective of any legislation in this area should be to assure that in a marketing arrangement where an individual is basically running his own business of buying goods and selling them at self-determined prices, and rendering service in connection therewith, to the general public, the law clearly provides for the treatment of such person as an independent contractor without any further inquiry being necessary. Unless this clear-cut protection is provided in the law, it is believed that many situations will still exist where it is difficult for people engaged in selling operations to establish a safe harbor, thus, imposing upon them the burden of establishing their status under the traditional common law rules. Common sense requires that in a situation where no money is passing hands except for the goods purchased and there are no payments from which to withhold taxes, the situation must be regarded as that of independent contractor. We hope the efforts of this Subcommittee will provide this category of individuals and the people they deal with some relief from the constant threat of having their status challenged.

The fourth requirement of the safe harbor provision provides "the individual performs the service pursuant to a written contract between the individual and the service-recipient which was entered into before the performance of the service". There is no practical reason why the written contract must be entered into before the performance of services. The "before" language is only a trap for the unwary and should not be a mechanism for the Service to prevent an innocent individual from falling within the safe harbor rule. The purpose of the written contract requirement is to provide notice to the independent contractor, thus the time the written contract was entered into should be irrelevant. Alternatively, the requirement could be moderated to provide that the parties have 30 days to enter into a written contract.

New Proposed Section 6041A(b)(1) requires an information return to be filed on direct sales of $5,000 or more. In keeping with the intent of this provision, as expressed in the explanation, the provision should be limited only to sales to individuals who have insignificant investments in tangible assets which are needed in the performance of the resales in the home. In such a case personal cars owned by the direct buyer would be considered a personal asset rather than an investment, with samples, catalogs, and displays constituting insignificant investments. For example, see the limitation found in Proposed Section 3508(b)(3)(B)(i). By making this qualification, the new provision will continue to apply to direct sales to sale representatives while removing any possible ambiguity in interpretation of the statute.

In a situation in which an independent contractor has employees of his own, who render services to others, it is essential that any legislation enacted will prevent duplication of withholding for income tax purposes and for the employee's share of FICA taxes; and to preclude a dual tax burden in regard to employers' share of FICA and FUTA provisions. It should also provide for the designation of which of the contracting parties is the individual's employer for purposes of employee benefit plan coverage.

Frequently, it is necessary to establish, on a limited basis, a relationship with an outside consultant in order to gain the benefit of expert knowledge not otherwise available. Any legislation should assure that an individual will not be considered an employee in a situation where an outside consultant is engaged to perform a specific task on an ad hoc basis. Such individual would probably have difficulty in meeting other criteria of the proposed legislation. Therefore, we suggest that the third alternative requirement of proposed Code Section 3508(b) be expanded to include the situation where an individual would not be able to meet the investment or income fluctuation criteria but would be covered if the retention of service is limited in scope with regard to time or the nature of the services.

The retroactive reclassification of individuals as employees, and assessment of taxes against the alleged employers, should be barred where treatment has been in good faith upon a reasonable basis. Such reclassification should be allowed only where fraud has been practiced, and even in such a case, the IRS should be required to examine its own files with respect to the reclassified workers to determine the income and employment taxes already paid by such worker, which amount should be allowed as an offset against any assessment, as is the case under current law.

As Mr. Justice Brennan stated in his concurring opinion in the Central Illinois case, supra, there is no evidence of any "congressional intent to make employers guarantors of the tax liabilities of their employees, which would in all likelihood be the result if withholding taxes can be assessed retroactively."

Neither, could it have been the intent of Congress in enacting the withholding statutes that income and employment taxes were to be collected twice on the same income.

The jurisdiction of the Tax Court should be extended to controversies where controversies relate to employee/independent contractor issues. This will bring the expertise of the Tax Court to such controversies, and will remove the necessity of reclassified employers to face bankruptcy by paying assessed taxes prior to litigating the controversy. H. R. 4531, introduced September 21, 1981, by Representative Conable, contained such a provision.

Administration Proposals

In a statement to the Subcommittee on Oversight of the IRS, Assistant Secretary of Treasury Chapoton on April 26, 1982, supported the retention of the common law and a safe harbor test. Under his view, however, the safe harbor would apply only if the individual is paid on other than an hourly or salaried basis and meets one of the following conditions: (1) The worker maintains a principal place of business, including a part of the house qualifying under Section 280A, (2) has substantial assets used in connection with the performance of the services, or (3) incurs substantial unreimbursed expenses.

The problem with this type of safe harbor provision is that it over-emphasizes the importance of how payment is to be calculated. If payment is made on hourly or salaried basis the safe harbor cannot apply. The distinction between employees and independent contractor revolves around the question of control versus independence. The issue of how payment is to be calculated has no relevance to either and should not be part of the safe harbor.

The Assistant Secretary also proposes an "anti-switching" rule which would prevent employers who have treated their workers as employees under current law from switching these workers to independent contractor status merely because insubstantial changes in the employment relationship could qualify under the safe harbor provision as proposed.

We see no reason why an employer, on a prospective basis cannot change the status of a relationship he has with a service provider. In fact, the concern of the Assistant Secretary dealing with prospective problems of the safe harbor provision, vividly illustrate the concern of the API with respect to the retroactive application of a change in an individual's treatment as an employee rather than an independent contractor.

The Assistant Secretary has suggested that the information reporting threshold be reduced. While the API recognizes the IRS' need for information to insure compliance, this need must be balanced against the administrative burden placed on the payor and IRS' ability to use the information and enforcement if received. The present threshold levels provide such a balance. Decreasing the threshold only penalizes the payor. The payor is not the one who is failing to pay.

The Assistant Secretary urges that the penalty for failure to file an information return with respect to independent contractors be imposed without a statute of limitation. S. 2369 presently contains such a provision. API commends its inclusion and suggests that the limitation period should be reduced from six to three years so as to reduce the record keeping burden of the payors.

The Assistant Secretary stated that the penalty provisions are too complex. As we have already pointed out, one problem of the bill is the complex penalty provisions. Thus, we suggested that the penalty provisions be eliminated with penalties being determined by the general penalty provisions which apply to all 1099 Forms. Unfortunately, the Treasury has suggested an alternative complex penalty provision, based on a percentage of compensation not reported. The Assistant Secretary has contended that simplicity is served by this alternative. API disagrees. Simplicity in administration can only be served if the same penalty provisions apply to all 1099 Forms.

The Treasury agrees with S. 2369 that payors to independent contractors should withhold amounts when erroneous or no identification numbers are provided by the independent contractors. Once again the wrong party is penalized. How is the payor to know if an erroneous number is furnished? The law should penalize those who provide the wrong or no information.

The Treasury has argued that prepayment review in the Tax Court not be available. Its reason is the present heavy court load in the Tax Court and the fact that a taxpayer can have access to the Court of Claims or District Courts based upon payment of a small fraction of the amount at issue. Granted there is case law which upholds this position. However, there is no guarantee that the Service will not change its position on the subject or that other courts will not conclude otherwise. Thus, the Tax Court route to litigation is necessary to assure a fair tax system.

Finally, the Assistant Secretary stated his concern on the retroactive application of an individual's status as an employee when the employer had a reasonable basis to treat the worker as an independent contractor. Possible solutions were advanced. However, in the API's view if a reasonable basis existed to treat a worker as an independent contractor, the only logical and fair solution would be not to have the rule applied retroactively.

Suggested Changes to S. 2369

Deletions = ~~Slashes/thru/deletions~~

Additions = Line under additions

The following is a suggested amendment to Section 2, S. 2369 pertaining to IRC Section 3508 on page S. 3510 beginning at the end of the first column:

"(a) GENERAL RULE. Notwithstanding any other provision of this subtitle, solely for purposes of this subtitle (other than Chapter 22) and Chapter 2 if ~~all/of/the~~ four-of-the-five requirements of subsection (b) are met with respect to service performed by any individual or if the activity of any individual principally involves the selling of tangible personal property, including the rendering of service in connection therewith, and the individual makes his own purchases of such property and determines his own selling price -

"(1) such service or activity shall be treated as being performed by an individual who is not an employee, and

"(2) the service-recipient or the person from whom such tangible personal property is purchased shall not be treated as an employer with respect to such service."

The foregoing amendment covers marketing arrangements whereby an individual is running his own business.

The following is a suggested amendment to Section 2(a) of S. 2369 dealing with proposed new IRC Section 3508(b)(4) found in the middle of column 2 of page S. 3510.

"(4) WRITTEN CONTRACT AND NOTICE OF TAX RESPONSIBILITIES.-

(A) Written Contract. - The individual performs the service pursuant to a written contract between the individual and the service-recipient -

~~(i) which was entered into before the performance of services, and~~

~~(ii)~~ which provides that the individual will not be treated as an employee with respect to such service -

~~(I)~~(i) for purposes of the Federal Insurance Contribution Act, the Social Security Act, and Federal Unemployment Tax Act, and income tax withholding, and

~~(II)~~(ii) for purposes of the employee benefit provisions specified in subsection (e)(2)."

The intent of this amendment is to make sure the intent of the safe harbor provision is not lost on meaningless technicalities. The intent is for the independent contractor to be on notice of his tax responsibilities without emphasizing when the notice is given.

The following is a suggested amendment to Section 2 of S. 2369 dealing with IRC Section 3508(b)(3)(A), on page S 3510 middle of second column

"or

(iii) Is retained under circumstances under which there is no assurance of continuity. (For example where retention is limited to a specific project or several specific projects.)"

The title of Section (3) should be changed to reflect this addition.

This amendment clearly covers the short duration independent contractor not able to meet either of the other criteria but whose services are of a limited duration.

The following is a suggested amendment to Section 2 of S. 2369, dealing with adding a new IRC Section 3508(c)(5) beginning in middle of third column on page S 3510:

"(5) Special Rule Where Certification of Employment Status is Obtainted -

Except where the Secretary proves fraud or bad faith in the case where a contractor -

"(A) contracts to perform services for another person;

"(B) directly compensates an individual for performing such services; and

"(C) certifies in writing to the person for whom such services are to be performed prior to the time such services are performed that the contractor is the employer of such individual for purposes of chapters 21, 23, 24, and subchapter D of chapter 1,

the person for whom such services are performed shall have no liability in respect of such individual under chapters 21, 23, 24, and subchapter D of chapter 1. For purposes of this paragraph, the term "contractor" means the person contracting in writing to perform services for another person."

This amendment prevents duplication of withholding and provides designation of employer for pension and retirement benefit purposes.

Immediately following the preceding amendment to S. 2369 add new IRC

Section 3508(c)(6):

"(6) Special Rules Relating to Effect of Retroactive Determination on Employee Benefit Plans -- If for a taxable year an individual performing services is treated as other than an employee by the person for whom such services are performed and a final determination is made subsequent to such taxable year that such individual is an employee of such person, subchapter D of chapter 1 shall be applied as if such individual were other than an employee of such person for the period prior to the taxable year beginning after such final determination is made."

This amendment will prohibit retroactive disqualification of qualified pension, profit-sharing and employee stock ownership plans of an employer as a result of a reclassification of non-employees as employees.

The following is a suggested amendment to Section 2 of S. 2369 dealing with IRC Section 3508(d) found on page S 3510:

"(d) No Inference. - If ~~All the~~ four-of-the-five requirements of subsection (b) are not met with respect to any service or if the activity of an individual does not otherwise qualify as that of an independent contractor under subsection (a) -

"(1) nothing in this section shall be construed to infer that the service is performed by an employee or that the person for whom the service is performed is an employer, and

"(2) any determination of such issue shall be made ~~as if this section had not been enacted~~ in accordance with the common law test."

This change conforms the marketing arrangements provision.

The following is a suggested amendment to Section 3(a) of S. 2369 relating to Proposed IRC Section 6041A(b)(1)(A) found at the end of first column of S. 3511:

"(b) Direct Sales of $5,000 or more . -

"(1) In General. - If -

"(A) Any person engaged in a trade or business in the course of such trade or business during

> any calendar year sells consumer products to a buyer (who himself has an insignificant investment in his sales business) on a buy-sell basis, a deposit-commission basis, or any similar basis which the Secretary prescribes by regulations, for resale (by the buyer or any other person) in the home, and"

The foregoing amendment clariries the scope of the new reporting requirement so that only sales representatives are covered by the new provision.

Section 3(b) of S. 2369 adding Proposed Section 6660 and beginning in the middle column of page S. 3511 should all be deleted. This change removes the complicated and unnecessary penalty provisions.

Similarly Section 3(c) of S. 2369 which adds Proposed IRC Section 3402(3) should be deleted. It begins on the left hand column of S. 3512. This amendment removes the withholding obligation on certain payments to independent contractors.

STATEMENT
on
THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND
COMPLIANCE ACT (S. 2369)
for submission to the
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Rachelle B. Bernstein*
April 26, 1982

The Chamber of Commerce of the United States, representing over 240,000 businesses, trade associations, and local and state chambers of commerce welcomes the opportunity to submit testimony on S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982.

Summary

The Chamber commends Senator Dole on his proposed legislation dealing with the difficult problem of classifying workers for tax purposes as employees or independent contractors. Important tax consequences result from this classification, and S. 2369 provides certainty in making that classification by establishing a "safe harbor" test that businesses can rely upon to ensure that individuals providing services to them are self-employed independent contractors. The Chamber supports this legislative effort which adequately deals with the independent contractor problem without requiring withholding.

Nature of the Problem

A significant difference exists under current law between the tax treatment of employees and independent contractors. An independent contractor does not have

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Federal Insurance Contributions Act (FICA) taxes or income taxes withheld from his or her remuneration, but must make these payments directly to the Internal Revenue Service (IRS). The business that uses an independent contractor is not liable for tax under the Federal Unemployment Tax Act (FUTA), or for the employer's share of FICA taxes, and also avoids the administrative burden of withholding.

Under present law, an individual is considered an employee for withholding purposes if the common law relationship of employer/employee exists. The income tax regulations define this relationship in the following manner:

> Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. Treas. Reg. Section 31.3401(c)-1(b).

Thus, the determining factor under the common law test is the degree of control which the employer has over the worker.

The definition of employee for purposes of social security and federal unemployment taxes is virtually identical. The only major difference is that persons engaging in certain occupations are classified by statute as employees for social security tax purposes, regardless of how they would be treated under the common law test.

Even though the common law test has existed for many years and has been the subject of numerous court decisions, there are no clear and concise rules for deciding what degree of control is enough to make an individual an employee.

For example, the Internal Revenue Manual, which gives guidance for Internal Revenue agents involved in the audit process, contains a list of twenty factors, based on common law, which agents consider in making this determination. None of these factors is controlling, nor is the fact that a majority of them would indicate that a given individual should be classified as an independent contractor.

The lack of certainty in the common law test can be particularly hard on the business or individual paying for the services (the payor). It is the payor who must decide whether the person performing the services is an employee or independent contractor. If the payor decides the person is an employee, then the payor must generally withhold income and social security taxes from the amounts paid out and pay the employer's share of social security taxes and the federal unemployment taxes. If the payor decides the person is an independent contractor, the payor has no responsibility to withhold or pay employment taxes. The person receiving the payments, the payee, then has the direct responsibility for paying income and social security taxes directly to the IRS.

The consequences of mistaken classification can be serious. If a business has individuals reclassified as employees, that business would owe the income and social security taxes it should have withheld, along with the employer's share of social security taxes and federal unemployment taxes for all years not barred by the statute of limitations. The business would be able to reduce the amount due for the income taxes it should have withheld only if it can obtain sworn affidavits from the reclassified workers stating that they had paid their income taxes. The social security taxes paid by an independent contractor under the Self-Employment Contributions Act (SECA) cannot be used to offset the employer's share of social security taxes. The reclassified worker may request a refund of the excess of social security funds, but no effort is made by the IRS to notify the worker of this right.

The effect of reclassification may extend beyond employment tax problems. The law permits an independent contractor to establish a Keogh plan and contribute up to $15,000 a year into that plan, as well as contribute up to $2,000 a year into an individual retirement account (IRA). In addition to an employer-sponsored pension plan, an employee may establish only an IRA, which has a basic contributions limit of $2,000. An IRS determination that an individual is an employee would mean the earlier contributions to a Keogh plan were improper and, therefore, not tax deductible. It might also mean a reduction in the potential retirement savings of that individual.

A business could suffer a similar fate. ERISA requires that certain percentages of a firm's employees be included in a retirement plan in order for contributions to be tax deductible. The sudden reclassification of a number of individuals to employee status could cause disqualification of the plan. The additional costs of bringing the newly classified employees into the plan may cause the business to abandon it altogether.

In the late 1960's and early 1970's, the IRS increased its enforcement of the employment tax laws. Reclassification by the IRS from independent contractor to employee status resulted in large tax liabilities for many businesses which had traditionally treated their workers as independent contractors.

The Revenue Act of 1978 provided temporary relief from the effects of retroactive IRS employment tax audits to persons who, acting in good faith, had treated the individuals performing services for them as independent contractors. The act terminated pre-1979 employment tax liabilities for these taxpayers and also prohibited the IRS from issuing any new rulings or regulations on this issue until January, 1980. This moratorium on the issuance of rulings and regulations by the IRS was later extended to June 30, 1982.

Legislative Solution

The Chamber supports creation of a broad "safe harbor" test, codifying the standards which evolved under common law and providing relief from the uncertainty created by IRS interpretation of the common law test. S. 2369 achieves this goal. The bill would not change the reasoning behind the classification of workers as either independent contractors or employees under the common law test. The amount of control exercised by the person for whom services are performed would still determine the proper classification. The bill would merely provide the self-employed and the business using the self-employed with a guarantee that, where the standards are met, the IRS would treat the worker as an independent contractor. Consequently, taxpayers would be relieved from IRS retroactive reclassification of independent contractors as employees which would result in retroactive assessment of employment taxes, double taxation where taxpayers paid withholding assessments for the same liabilities for which workers had paid income tax, overpayments of social security taxes where taxpayers pay FICA taxes with respect to workers who had paid SECA taxes, and disqualification of retirement plans.

The Chamber opposes imposition of withholding on independent contractors. Withholding does nothing to help a business solve the real issue -- determining whether an individual is an employee or an independent contractor.

CONCLUSION

Many businesses and individuals have relied for years on the belief that the common law test established the individuals' tax status as independent contractors. Assertions by the IRS that many of these individuals were instead employees has brought increasing uncertainty to the common law test. Although the moratorium on IRS issuance of regulations and rulings in this area has provided a temporary solution to this problem, we hope that a permanent legislative solution can now be achieved.

We commend this subcommittee for holding hearings on this issue and extend the Chamber's support for legislation, such as S. 2369, creating a "safe harbor" test which provides certainty without extending independent contractor status to persons presently classified as employees and without imposing a new withholding system on independent contractors.